Efficient law

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EFFICIENT LAW

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EFFICIENT LAW

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Introduction

This dissertation challenges at least two important threads of economics which are widely accepted by various streams of the economic profession.

- a. I believe that the concept of "efficiency" has been ill-defined and therefore misunderstood and inappropriately used by virtually every economist concerned with law and economics and public choice.
- b. With the important addition of the concept of what I call a "national economic style," I question whether most of the accepted theory of the firm analysis is universal and therefore valid. One key element on the national economic style is to bring together the corresponding inverse relationship between contracting costs and monitoring costs.

In the concluding chapters, this dissertation includes several challenges for governments and the legal profession. Even within a "Single European Market," countries are competing fiercely with each other for scarce investment capital, tax revenues and incorporations. Governments will use three instruments to help themselves compete for these scarce resources: investment incentives (subsidies); tax breaks; or more liberal company laws. This governmental competition is not mere conjecture; as one member of the European Commission told me privately: "each Member State is trying to become a tax haven from the other eleven Member States." International investors are playing one country off against another for subsidies which come in various forms and tax benefits. This dissertation will maintain that the underlying tax and company laws which were mostly formulated for national domestic reasons, are increasingly under competitive pressure from the laws of neighbouring countries. For countries the stakes are large. The winners receive and retain investments, tax revenues and corporate charters; the losers will lose them and force further competition for these scarce resources. Where the equilibrium point ends up cannot yet be foreseen, but it is unlikely that government will be able to tax corporations or the ownership of capital in the foreseeable future.

The underlying philosophy taken is that countries have a strong incentive to pass the most efficient organizational forms as possible in order to maximize the amount of economic activity which occurs in their jurisdiction. The fact that all countries have not adopted the same means does not necessarily mean that one or more laws are not efficient. I believe that any talk regarding movement toward a "European Union" with harmonized law in most areas for the purpose of creating a European Utopia is naive. No country is altruistic. Every country only agrees to progress on harmonization if the proposed movement is regarded to be in its interest. The combination of these premises leads me to the result that many current laws which facilitate transactions and trade might well be efficient and that total harmonization will only take place if and when national interests coincide.

This thesis will be driven by a belief that markets work in ways where economic actors respond to opportunities which present themselves. It will be divided into two sections. The first part will outline my overall approach to the field of law and economics. This part is comprised of four chapters which all centre on efficiency. It is my contention that all laws should promote efficiency and values. It is also my contention that inefficient laws will inhibit efficient markets. What makes my arguments distinctive is that I find most economist's definitions of efficiency to be inappropriate for law and economics or public choice purposes. I contend that both inputs and outputs are usually ill-measured. A proper definition of efficiency must take into account all inputs (which includes the conditions under which the market operates) and insure that the inputs are properly priced. My definition of output is not confined to a measurement of profits or physical output. The output of an efficient market should maximize the aggregate amount of satisfaction of a society.

The first chapter of this dissertation is entitled "Laws, Markets and Efficiency." It spells out the proposition that markets are based on a set of legal norms (sometimes referred to as market conditions) and defines what efficient markets and efficient legal norms are. Efficient market conditions will beget efficient markets.

The second chapter of this thesis is entitled "Efficient Domestic Background Law." In order for commercial transactions to efficiently take place, a legal infrastructure must be in place which minimizes uncertainty and risk as well as transaction and agency costs. In this chapter, I try to debunk some of the speculation that an implied contract theory is efficient. In doing so I recognize that company laws have been formulated to address the

sometimes competing interests of five economic actors who have the greatest concern over company law: investors; creditors; managers; employees and the government. Their various interests are outlined. The conclusion is that efficient domestic background law must balance competing interests and create adequate minimum standards.

The third chapter is entitled "National Economic Styles." Various countries have their own experiences, laws and institutions. Together they create a spirit and general consensus which transcends a political spectrum.

The fourth chapter is entitled "National Economic Styles and Efficiency." The idea of a national economic style and efficiency is predicated on the question: Can two different markets be based on different market conditions and each be efficient? This question arose after I had been to a few conferences in which various problems were discussed. I noticed that virtually every speaker used his country's experience to indicate how and why certain common problems should be handled in one way or another. I also noticed that most listeners would roll their eyes when this solution was proposed and then go on to explain why their countries' responses were the correct solution to the common problem. By implication most people felt that a proper solution to a common problem must be universal. I came to the conclusion that each solution might be efficient when: (1) the solution properly reflected the collective values of the society and (2) national institutions and laws are correctly structured to reflect these values. Collectively I refer to the collective national values and institutions as "the national economic style." In these chapters I come to the conclusion that each national economic style imposes its own distinctive transactions cost, monitoring costs and agency costs which may mandate different efficient solutions and laws to commonly shared problems. By doing this I will maintain that various laws pertaining to a single issue can be simultaneously efficient.

By maintaining that more than one type of public company or company law may be efficient and indeed appropriate for different countries, I will directly contest most of contemporary theories regarding the nature of the firm. My work will be mostly descriptive; I will maintain that much of current theory is prescriptive. While there is nothing inherently wrong with being prescriptive, it is wrong when the proclaimers mandate one universal organizational form or company. These commentators err because they do not take into account differences in economic styles which can lead to radically different values, transactions costs, agency costs and monitoring costs. These differences may have a profound economic effect.

The second part of the thesis centres on how technology has changed the equation of efficient domestic law. It builds on builds on the view expressed in the first part regarding the relationship between laws, markets, efficiency and national economic styles.

It begins with a transitional chapter entitled "The Brave New World of Intergovernmental Competition: Efficiency in an International Setting." Technology has made travel and communication relatively fast and inexpensive. As a result both firms and individuals have greater choice over who they do business with and which laws to use. This chapter attempts to explain how the world has changed over the last generation and why, as well as the consequences of these changes.

The major consequences of these changes are outlined in chapters 6 and 7, "Supply-Side Law" and "Supply-Side Tax Policies." Because of increased global consumer choice and the necessity to pay for social spending, governments are competing to attract internationally mobile investment in order to attract jobs and increase revenue. Since international investors seek the highest return possible at a given level of risk, governments have had to compete against each other to enact attractive laws and tax policies to create jobs and much-needed revenue.

Chapter 6 describes over twenty types of supply-side laws. These are laws which are supplied by governments to promote economic activities and tax revenues.

Chapter 7 concludes that the current regimes have strong negative economic and fiscal consequences and that international investors (primarily corporations) will probably not be taxed in the near future.

The final chapter, "The Proper Source of Efficient Commercial Law in an International Environment: Company Law and Capital Markets," asks where efficient law should come from. In a world where individuals and firms

have a choice of picking the laws under which they operate, greater thought must be given to the proper source of efficient law. Law which is efficient in this context must be based on the subsidiarity principle: laws should be passed at the lowest level practicable. The proper source and form of efficient laws will depend on the law's purpose and the nature of the market which is meant to be regulated. Toward this end, this chapter will go into some detail regarding the future of laws regulating capital markets, currencies and the operations of companies. In the past, all were formerly regulated at the national or more local level, but there is an increasing shift to the international or pan-national level. This chapter asks, at a time when money, capital markets and the structures of firms are increasingly becoming international in nature, which of these should be regulated by national, by regional and by international laws. This chapter argues that the international level is appropriate for capital markets, that currencies are best regulated at the point where economies become integrated, and that the national level is more appropriate for company laws. This is because the capital markets, in which capital seeks the highest rate of return for a given level of risk, are international. Company law, on the other hand, seeks to regulate the relationships of people and groups by either suggesting or imposing governance structures. The appropriateness of any given operating structure is determined by the working relationships, level of trust and national economic style of a company's stakeholders.

When I began working on this dissertation I intended to state the reasons why company law harmonization would occur and what the economic effects of a single European company law would be. After giving the matter further consideration I concluded that meaningful harmonization would not occur in the foreseeable future. Instead of abandoning the project, I decided to use an Occam's Razor which is a principle proposed to guide academic inquiry. It stipulates that simple explanations should be preferred to complex ones and that complexities should only be introduced when simple explanations prove inadequate. In doing this, I thought an equally important and interesting study would be to determine why harmonization does not take place, even though some people might believe that harmonization is preferable. Treading on this side of the Razor requires using a form of backwards logic. Once one accepts the possibility that governments might know what they are doing and may already be acting in their own best interest for economic reasons that can be clearly articulated, the explanation becomes simpler. This realization requires two other perplexing questions to be answered: Can two different solutions to the same problem be equally efficient when the inputs are essentially equivalent? If there can be two equally efficient solutions to the same problem given essentially equivalent inputs, what other factors are at work? Only after these questions were fully understood and were properly answered in my mind did all of the disparate parts become clear. I hope that through this dissertation, I can make my understanding of economics and efficient law in an international setting equally lucid.

Chapter 1: Laws, Markets and Efficiency

Abstract

In this chapter it will be argued that laws, markets and efficiency should be considered simultaneously, as there is a natural reciprocal relationship between them. Markets operate according to the constraints placed upon them by the customs, rules and enforcement provisions which regulate markets. These legal norms are the basis upon which goods and services are priced (or not priced). The only legitimate goal of public policy should be to create efficient markets. This chapter defines efficiency as the use of available resources in ways which bring about the maximum satisfaction possible, given the available technology. Efficient markets will price all scarce resources in such a way that will maximize the satisfaction of the entire society. This can only occur when markets operate under the guidance of an efficient set of laws and regulations which are consistently and effectively enforced. One aspect why authors in the fields of law and economics, institutional economics, and public choice have not always been able to make this natural connection between law, markets and efficiency is that they take a narrower view of the term "efficiency." It is argued that efficiency has often been ill-defined and improperly used because inputs and outputs have also largely been improperly measured. Based on the integration of laws, markets and efficiency, this chapter concludes by outlining when government activities can be seen as being both efficient and legitimate.

Chapter 1: Laws, Markets and Efficiency

"What Can Economics Contribute to Its Neighbours?"
To Law - Limitations
To Political Science - A Theory
What Can Economics Learn from its Neighbours?"
From Law - A Framework
From Political Science - Data"
*-J.M. Buchanan [1966]*¹

Rules and their enforcement will determine how markets operate. The rules under which markets operate will determine many things including the supply, demand and price of labour, capital, property, goods and services. The price which the market sets will help determine whether market participants will choose to buy, sell or not participate in the market: save, spend or invest; or work, remain idle or enjoy leisure.

Markets will and do work. When markets are said to be "failing" or working "badly" it is not because the markets themselves "fail" or are "bad;" negative results occur when the set of rules under which the markets operate are either inherently inadequate, property rights are unclear or the rules may be adequate but improperly enforced. Fortunately, in many instances bad, inefficient or ineffective rules and inadequate enforcement can be overcome. Societies organize themselves with governments which generally have the power both to make or amend rules which come in the form of laws and regulations, and to enforce these laws and regulations through a system of courts and administrative bodies. "Bad" market rules can and should be overcome by effective public policy. The goal of public policy should be to create efficient rules (in the form of laws and regulations and their enforcement). It is the provision of efficient laws which will provide the remedy to markets which are said to "fail" or are "bad."

The question that should then arise is: what are efficient laws, effective public policies, and useful government actions? That is what this chapter shall attempt to address. In order to answer these questions, a determination of the relationship is: (1) between laws and markets; (2) between markets and efficiency; and finally (3) between laws and efficiency, is appropriate.

Section 1: Laws and Markets

Markets are arrangements in which providers and consumers of capital, goods and services interact to determine the prices and the available quantities of capital, goods and services. Markets operate according to a set of legal norms. Legal norms are market rules and enforceable property rights which have been developed through laws, constitutions, regulations, tax policies, trade practices, culture, religion and customs. Together these sources of legal norms determine the form and the structure of the market.²

Changes in the law or the manner in which it is enforced necessarily affect the form and the structure of the market. There is no excuse for those in the public choice or law economics fields not to centre their analysis on the relationship between laws and markets. Since these fields are concerned with legal (including governmental) institutions and the creation and the enforcement of law and regulations, they should certainly realize that any change in the law or its enforcement is intended to affect individual, governmental or firm behaviour. Any change in behaviour will necessarily affect one or more markets. Markets will respond by changing supply and demand

¹ J.M. Buchanan, "What Can Economics Contribute to its Neighbours?", in S.R. Krupp (ed.), *The Structure of Economic Science* (New York: Prentice-Hall, 1986) pp. 8-24 at 8.

² A.A. Schmid presents this concept in a slightly different way: "Law is a function of the economy and the economy is a function of the law, and this constitutes the legal-economic nexus." "Institutional Law and Economics: A Survey", *Staff Paper* No. 91-27, Michigan State University (April 1991) at 2.

patterns for at least one good or service (considering criminal acts to be a type of service). The change in one market will affect other markets since consumers' income or other preferences will also have changed.

The cost of establishing and enforcing property rights will affect market operations and may have a dramatic effect on the supply, demand and cost of the product or service in the market.³ While laws and markets should always be considered simultaneously, they often are not. This is unfortunate since legal norms can radically affect market operations.

1. How Laws Affect Markets - Two Examples

To illustrate how legal norms can affect markets in different ways let us take two examples of markets: labour and real estate. Even given similar skill levels in their labour force and similar functions for real estate, one often finds vastly different prices and patterns of usage in different countries and localities. Markets may function differently and produce different results because the legal norms under which they are formed and operate may lead to radically different patterns of both supply and demand. The legal norms which affect the demand and supply of labour and of real estate will be discussed separately.

a. The Labour Market

National laws, regulations and tax policies, as well as culture, religion and customs, greatly influence the supply and the cost of labour. The supply of labour is directly influenced by factors such as individual income tax rates, the social security structure, the cost and availability of transportation, retirement ages and pension benefits, the availability of child care, acceptance of women and minorities into the work force, the amount of training and the regulation of operating hours. The demand for labour is influenced by factors such as minimum wages, social security payments, labour regulations, the education level of the work force, the cost and availability of training, the cost of capital and the structure and financing of the health care system.

If it were possible to equalize these factors, it is reasonable to assume that the witnessed differences in labour participation rates and unemployment rates between countries would narrow. Participation rates (particularly of women) may be low in some countries due to high income tax rates and social security contributions, high unemployment and social security benefits, the unavailability of child care, a low acceptance of women and minorities into the work force, highly regulated working hours or cultural factors. Unemployment rates may be higher in countries in which unemployment insurance is generous, laying off or firing people is expensive, or minimum wage rates, social security, health care and pension fund contributions are high.

b. The Real Estate Market

Culture and governmental laws, regulations and tax policies greatly influence the supply and the cost of real estate. The supply of property is directly influenced by tax laws, zoning laws, tenant rights, rent controls, building codes, and the cultural importance of land ownership. The demand for real estate is influenced by these same factors as well as wealth, income and the cost and availability of credit.

For example, on a purely economic basis, one would have great difficulty explaining why, according to prices paid in 1989, the whole of Japan (378,000 square kilometres) was valued at more than the whole of the United States (9.4 million square kilometres).⁴ The relative land values are even more startling when one considers that Japan has fewer buildings, lower per capita income and relatively fewer natural resources and less arable land

³ It may be useful to think of a black market in this context. The black market price is a true free market price. It is more efficient than the "official price." The black market price should better mirror supply and demand conditions. The black market price should be influenced by the "official" price of the good, the risk in selling it illicitly and the amount of time which one has to queue for the product if it could be had legally.

⁴ "Growth's Dead Weight", The Economist (June 15, 1991) p. 13.

than the United States. Only when the differences in supply and demand factors mentioned above are considered can one begin to attempt to provide some sort of explanation for the extraordinary difference in land values.

2. Different Legal Norms, Different Markets

If the definition of a market is an arrangement where buyers and sellers can interact to determine the prices and the available quantities of goods or services, it must be asked why different markets for similar goods and services determine different quantities and prices for these goods and services. One reason may be that the underlying legal norms of the markets may be completely different. Since virtually every country has its own distinctive legal system pertaining to real estate and labour (products which are either not transportable or necessarily mobile), comparing markets on a country by country basis may be like comparing apples and oranges. Whether the national markets for these economic goods are efficient is a different issue.

Section 2: Markets and Efficiency

In order to determine whether markets are truly efficient, it must be asked what constitutes an efficient market and efficiency must be properly defined. A definition of efficiency which differs from the definitions which have been most commonly employed will be used and applied to the definition of an efficient market (based on outcome) and an efficient legal system.

1. Towards a Correct Definition of Efficiency

The concept of efficiency, although at the core of economic analysis, is less precise and less valid than one would expect. Even within neoclassical economic theory it does not always mean the same thing to every economist. Although there is general agreement that efficiency is centred on measures which either lead to some type of maximization or optimization, many of the concepts of efficiency used by economists are inappropriate for either public choice and law and economics purposes. A critique of how the public choice, law and economics or institutional law and economics fields have treated the term "efficiency" is covered in the Appendix to this chapter.

In economic terms, efficiency is determined by only two factors: (1) the level of inputs and (2) the amount of output which results. It is in the measurement and determination of inputs and outputs that many concepts of efficiency are inadequate for both public choice and law and economics purposes. As a result, there are problems with both the commonly understood microeconomic and the macroeconomic definitions of efficiency.

a. A Correct Measurement of Inputs

In economic theory, inputs are usually confined to three variables: natural resources, capital and labour. This is insufficient. Markets rest on a set of legal rules. Variations in these rules present different opportunity costs. Government actions including law-making, taxation, regulation and bureaucracy may seriously enhance or detract from every element of an efficient market. These government actions will almost necessarily affect the supply or demand found in a market. These changes in supply and demand will be reflected in the price of a commodity, good or service. As with the supply and demand of natural resources, capital and labour, market rules can be changed. Since market rules can alter the patterns of both the supply and demand for natural resources, capital and labour, *and are not fixed*, market rules should be seen as an input. The exclusion or lack of understanding of the role which governments and legal systems play in the market place may produce markets which are not economically efficient. It may also lead to erroneous economic theory, bad legislation or faulty economic policy. This will be further discussed below.⁵

⁵ Economists may ask what production function can the law have? The answer is that the law should be treated as an input.

b. A Correct Measurement of Outputs

Output is often confined to a measurement of physical output or profits. A proper measurement of output should be much broader - especially when considering public choice or law and economics issues. Output should be measured as the total amount of satisfaction (this is more commonly referred to as "utility") provided through the use of the inputs. The incorrect measurement of outputs by authors in the fields of public choice and law and economics is a common mistake. One reason for this mistake is that output is far more difficult to determine when considering satisfaction.

When considering satisfaction, one starts with an egalitarian premise: every person and every person's satisfaction has to be treated equally. If every person's satisfaction is deemed to be of equal value, the amount of societal satisfaction should be a simple aggregate total of the individual satisfaction functions. Trade-offs will always be necessary since virtually every law or other action will make some individuals worse off. What should be considered is whether, in light of all of the circumstances and likely outcomes, the total amount of satisfaction will be maximized as a result of a law or policy.

This may be difficult, since the absolute number of individuals helped and harmed by any law or policy should *not* be based on a simple head count. The intensity of feeling is more important. If relatively few people's satisfaction is augmented by an action, the action may be appropriate even if a large number of individuals are marginally harmed by the action (and would not vote for the action if a poll were to be taken).

For example, let's imagine a relatively peaceful island with a reasonable standard of living and no government sponsored social security programme. A natural disaster hits making a sizable minority homeless and a very small number of people permanently disabled. Local charity, insurance proceeds and international aid is insufficient to rebuild the lost homes and to care for the maimed. The local politicians decide to pass an undefined broad-based tax to make up for the shortfall. Let us assume that everyone on the island believes that this is a just and reasonable tax. The issue must now be, how large the tax should be and the form of the tax. While everyone may agree that the tax is necessary, many people would like to pay as few taxes as possible, while the recipients would like to receive as much compensation as possible. A balance must be struck. The optimal point of this balance should be at the point where the greatest amount of satisfaction is found in light of the circumstances. Depending on the feelings of the population the optimal point will range somewhere between totally rebuilding the destroyed houses to their former standard to putting up only enough money to build temporary shacks. The disabled people may receive generous assistance or minimal assistance (shifting the balance of their care to private charity).

Since measurement and aggregation are not simple to determine in this or any other instance, the general public designates agents to do this for them. These agents are commonly called "public servants." The public servants who are empowered to carry out this process are hired civil servants and elected politicians. Their task should be to determine which actions or non-actions will lead to the greatest aggregate output of societal satisfaction. In the above example, the issue is not whether the majority will help the minority, the issue is how much above a certain level the taxpayers will lose more satisfaction than the minority recipients gain. Finding the point of maximum satisfaction is a political question which must be left to trusted public servants. This calls for a balancing of competing interests. Buchanan and Tullock refer to this balancing of competing interests as a form of calculus.⁶

Satisfaction must be thought of in broad societal terms since most output can have both direct and indirect effects. Obviously physical output and profits provide satisfaction to their direct recipients or users, but the manner in which the inputs are used and the use of the outputs may also provide satisfaction, in the case of the firm, to workers, managers and other indirect participants in the production process. This satisfaction may also be directly attributable to output. Within the firm, an efficient set of company laws would (simplistically) result in a firm where total satisfaction is maximized in light of the owners' desire for profits, the managers' desire for productivity and the employees' desire for utility.

⁶ See generally, J.M Buchanan and G. Tullock, The Calculus of Consent (1962). Reprint (Ann Arbor: University of Michigan Press, 1983).

c. Efficiency and Adam Smith

Adam Smith was concerned with the concept of efficiency when he wrote The Wealth of Nations,⁷ but his definition of efficiency is not entirely applicable, because he was interested in national wealth rather than satisfaction.⁸ Nevertheless, the mechanism which can lead to maximization is the same in both cases.

Smith uses the concept of the invisible hand to demonstrate the process which approaches the production possibility curve (defined solely in terms of national wealth). The invisible hand works when individuals attempt to maximize their own satisfaction (not necessarily wealth). Out of all of this self-interest efficiency is achieved. Resources are scarce and therefore must be allocated. The market mechanism ensures that each individual places his own value on these scarce resources and the resources end up in the hands of the persons who place the highest value on them. If the value is high enough, others will devote resources from other sources to produce more of the scarce resource (if possible). This process is dynamic. If the markets are all efficient, meaning that information is widely available and transaction costs are low,⁹ the wealth of nations will be maximized. J. Bonner puts it well when he states that: "Markets are a device for making social decisions in the economic sphere. They determine *what* is to be produced, *how* it is to be produced, and by *whom* it is to be consumed, without recourse to physical force or central direction."¹⁰

2. A Correct Definition of Efficiency

After it is understood how both inputs and output should be measured, a correct definition of efficiency becomes simple: efficiency is the use of available resources in ways which bring about the maximum overall satisfaction possible, given the available technology. This definition does not accept existing market rules when the rules themselves do not lead to a maximization of satisfaction.

Within this definition, output is measured in terms of satisfaction, not physical output. A maximum satisfaction curve might well allocate resources in manners that would lie (considerably) below a society's production possibility curve since a society which seeks to maximize satisfaction may well allocate resources in a different way than would be expected if only individual utility curves and the production possibility curve are considered.¹¹

⁷ An Inquiry into the Nature and Causes of the Wealth of Nations (1776). Reprint (Clarendon: Oxford, 1976).

⁸ Both A. Rees in "Compensating Wage Differentials", in Essays on Adam Smith, A. Skinner and T. Wilson (eds.) (Oxford: Clarendon, 1976) at 93-112 and E.G. West, Adam Smith and Modern Economics (Aldershot and Brookfield, VT: Edward Elgar, 1990) point out that Smith listed five factors which constituted the non-monetary advantages and disadvantages of employment. They argue that these listed factors show that Smith was interested in maximizing satisfaction.

⁹ While a free flow of information and low transaction costs are prerequisites for an efficient market, they are not necessarily sufficient conditions for an efficient market. Both conditions are often present in stock markets, but when one notes that on October 19th 1987 the Dow Jones Industrial Index was worth 23% less than it was on its previous trading day (October 16th), one is left with the question whether the New York Stock Exchange operated in an "efficient" manner.

¹⁰ J. Bonner, Politics, Economics & Welfare (Brighton: Wheatsheaf, 1986) at 111.

¹¹ The majority position of the economics profession is that satisfaction cannot be aggregated. There is however, a long-standing minority position. See A. Bergson, "Reformulation of Certain Aspects of Welfare Economics", 2 Quarterly Journal of Economics 310-334 (1938). Reprinted in K. Arrow and P. Scitovsky (eds.), Readings in Certain Aspects of Welfare Economics (Irwin: Homewood Ill., 1969) pp. 7-25; and B.M.S. van Praag, Individual Welfare functions and Consumer Behaviour (Amsterdam: North Holland, 1968).

For example, one can argue that in overall terms, France maximizes its satisfaction by sponsoring the French language, French music, French television and cinema, French art, French fashion, French automobiles, French wine and French food. The French do this even though it might be cheaper and more technically efficient to use German where practical, listen to English music, import American movies and television shows, view Spanish art, drink Portuguese wine, wear Italian fashion, drive Japanese automobiles and eat food imported from eastern Europe. If France became more technically efficient by adopting foreign culture and consumption habits, a large segment of the population might enjoy listening to more English language music, watching more American movies and television shows, driving Japanese automobiles and eating cheaper food.

Becoming more technically efficient, however, has its own costs. Should Frenchmen decide that it is worthwhile to incur these additional costs, the French economy cannot sit on the perimeter of its production possibility curve. Sitting on the outskirts of the nation's production possibility curve is no panacea: many French men and women receive great satisfaction in the promotion of french food and culture. While economic theory might demonstrate that considerable trade benefits would be reaped, for instance, by switching to the German language, undergoing this change would almost certainly dilute the population's satisfaction derived from being "French." The costs would be so great that it is impossible to envision how these archetypal changes could increase French societal satisfaction.

Maximizing satisfaction should be considered on a societal basis, because it is the society which makes many of the laws which are an integral part of the market rules. As this definition of efficiency is different to the most commonly used definitions of the term by the microeconomics, macroeconomics, public choice and law and economics professions, a brief overview on how many economists tend to use the term "efficiency" is given and then the shortcomings of these definitions are pointed out.¹² The difference between the *status quo* and efficient law will be pointed out in later chapters.

3. Problems With the Microeconomic Definition

a. Efficiency of Allocation

At the microeconomic level, efficiency is reached when all resources are allocated optimally. The microeconomic definition usually derives from a definition of allocative or "Pareto" efficiency. This type of "efficiency" occurs when there is no other reorganization of production or consumption that will increase the satisfaction of one person without reducing the satisfaction of another person.¹³ This definition suffers from an inadequate measurement of both inputs and outputs. It is inappropriate for our purposes because it (1) takes the market as it finds it (there is no assumption that the market itself is either efficient or inefficient or can be changed); and (2) this definition does not assume that societal satisfaction is maximized.

b. Efficiency of Distribution

The use of Pareto efficiency is a mistake since it does not always lead to resource allocation which maximizes societal satisfaction. As A.K. Sen stresses, Pareto efficiency in itself is not "a momentous achievement from the point of view of social welfare. A person who starts off ill-endowed may stay poor and deprived even after...[trading] and if ...[efficiency is all that is on offer], the propertyless may be forgiven for not regarding the achievement as a 'big deal.'"¹⁴ As an example, let us take a society of 100,000 people with an aggregate wealth of 100 million units. In this society there is one happy, but greedy individual who owns almost all of the

¹² For an excellent review of the historical debate regarding efficiency see D.W. Bromley, "The Ideology of Efficiency: Searching for a Theory of Policy Analysis", 19 Journal of Environmental Economics and Management 86-107 (1990).

¹³ P.A. Samuelson and W.D. Nordhaus, Economics, Thirteenth Edition, (New York: McGraw-Hill, 1989) at 747.

¹⁴ A.K. Sen, "Rational Fools: A Critique of the Behavioural Foundations of Economic Theory", 6 Philosophy and Public Affairs 317-344 (1976/77) at 320.

wealth. The other 99,999 people are destitute. This one wealthy individual has a perverse utility curve in which he decides to spend his entire wealth on buying toxic waste from around the world and spreading it liberally throughout the entire country. Few people would argue that this is an efficient society. It would, however, be considered Pareto inefficient if he were required to stop spreading toxic waste. Even if spillover effects are eliminated from Pareto efficient analysis, it would also be Pareto inefficient to merely impose a tax on his wealth, giving him an incentive to invest instead of consuming or to redistribute any of his income. This is true even if society's needs and desires would be greatly served by such actions. One could imagine that societal satisfaction might well be augmented if some type of redistribution system were put in place where, through a small transfer payment, the richer person's satisfaction were marginally reduced while the starving people's satisfaction was greatly enhanced. This outcome would not be Pareto efficient (because the wealthy man is subjectively worse off), but it should be seen to be efficient from a law and economics or public choice perspective.¹⁵ As Samuels wrote, "the [Pareto] law is willy nilly wealth maximizing whichever or whosoever's interests it protects."¹⁶

Daniel Bromley delivers a harsh broadside at Pareto efficiency. It is one which has great merit.

The potential Pareto improvement criterion and other measures of economic efficiency do not pass the test of consistency and coherence within economic theory, nor do such measures accord with what public decision makers seek in policy advice from economists.... On surveying this [welfare economics] literature one is reassured that (1) efficiency, via the Pareto test, lends itself to rather precise measurement; and (2) economic efficiency seems to require 'the fewest value judgements' on the part of the researcher. Less reassuring are (1) the persistent debate over which welfare criterion is appropriate - Kaldor, Hicks, Scitovsky, Little, Mishan, or various combinations thereof; and (2) the Boadway Paradox, in which the ability of the gainers to compensate the losers does *not* lead to an unambiguous improvement of social welfare. More seriously, in all this prodigious elegance, rarely is there recognition that the Pareto test remains what it has always been - an analytical construct (inconsistent and incoherent at that) with no special claim to legitimacy beyond the tautological domain out of which it arose.¹⁷

Efficiency of distribution requires that all trades that can make both parties simultaneously better off are carried out. This definition not only suffers from the problems outlined above, but also fails to take into account the effects that transaction costs or taxes may have on possible transactions.

As an illustration, let us take two individuals, one of whom owns a house while the other owns shares in a listed company. Both the house and the shares were bought for 50,000 units and both have a fair market value of 100,000 units. Leaving aside transaction costs and taxes, they would both like to exchange their assets. This simple trade cannot be conducted in this manner. Stock market rules require that shares be traded on the exchange and that the shares be registered in the name of the new owner. Most countries have one or more property registration bureaus where changes in property ownership are recorded. Thus two 'sales' must be made, as opposed to a single trade. Neither of these changes in registration are costless.

The effect that taxes have on this transaction varies from country to country. Let me concentrate on two types of taxes which may alter the post-sale price: sales or value added taxes and capital gains or income taxes. Some countries may require that sales or value added taxes are paid on one or both of the transactions. This will lower the after tax net price received. Some countries also may tax the 50,000 unit capital gain made by either or both of the parties (the realized price minus the original purchase price). Regardless of the amount of the taxes, this will distort the amount of after tax units held by each of the parties and may prevent the parties from completing

¹⁵ A.C. Pigou came up with a similar example in The Economics of Welfare, Fifth Edition, (London: Macmillan, 1952) at 332.

¹⁶ W.J. Samuels, "Maximization of Wealth as Justice: an Essay on Posnerian Law and Economics as Policy Analysis", 60 Texas Law Review 147-172 (1981) at 148.

¹⁷ Bromley, *supra* note 12 at 86 and 96.

the trade. For example, let us say that the former shareholder paid transaction costs and capital gains taxes of 25,000 units. This means that he is now left with only 75,000 units. For 75,000 units he probably cannot buy a house with a fair market value of 100,000 units. On the other hand let us suppose that the former home owner received the entire 100,000 units, but had to pay transaction costs and sales taxes equal to 10,000 units. This means that he can only buy 90,000 units worth of shares. This trade may no longer be attractive or possible for him either.¹⁸

3. Problems with the Macroeconomic Definition

At the macroeconomic level, efficiency is often deemed to be reached when an economy's current output reaches the production (not satisfaction) possibility frontier. The macroeconomic definition usually derives from a definition of technical efficiency. This type of "efficiency" occurs when inputs (usually confined to natural resources, labour and capital) are used in the manner which maximizes output given the technology available. The criticism of this definition is similar to the criticism of the microeconomic definition: it does not attempt to measure satisfaction, nor does it consider whether the market itself is efficient.

Efficiency in production is said to be assured if all firms are producing at the point where price equals marginal cost; the place where competitive firms maximize profits. There are two problems with this contention, both having to do with the improper or inadequate measurement of outputs. (1) A worker may be most productive as a physicist, but he finds that he hates mathematics and wants to promote cold fusion by being a welder in Siberia. This change in employment may reduce productive capacity, but it will increase his utility. (2) Because the legal system is not considered to be an input, externalities are not necessarily measured either in terms of production or by productive capacity. This was and is one of the key reasons why Eastern Europe is so polluted. Pollution was not implicitly or explicitly counted as a by-product of "efficient production." In this situation, even assuming that each factor of production was used in its most productive capacity, producing at the production possibility curve cannot be considered to be an efficient outcome, because output was not fully measured.

4. What is an Efficient Market?

"To achieve static and dynamic efficiency a market system must be characterized by competition in all relevant markets and by the equality of private and social costs and benefits."¹⁹ A truly efficient market will accomplish this by providing efficient laws and efficient legal structures. Efficiency occurs when the aggregate amount of satisfaction is maximized with the available inputs and technology.

With this in mind, it seems logical to return to the question of whether two different markets, the labour and the real estate market can both simultaneously be efficient even if they are radically different. The answer must be yes if societal satisfaction is maximized in each country. An efficient market will be based on a system of efficient laws. If two radically different markets for the same product or service can be simultaneously efficient, the legal norms under which the markets operate must also be efficient since they produce markets which maximize satisfaction in the various societies. This concept will be further developed in Chapter 3: National Economic Styles and Efficiency.

Section 3: Law and Efficiency

As discussed above, markets exist within a framework of legal norms. The efficiency of a market is determined by the laws which provide its framework. This analysis differs profoundly from that of many lawyers, economists, and government officials. For instance, Kenneth Arrow denies in the very first sentence of his famous book "Social Choice and Individual Values," the interrelationship of laws, markets and efficiency. "In a capitalist democracy there are essentially two methods by which social choice can be made: voting, typically used to make

¹⁸ One should note that this example conforms to a Pareto analysis.

¹⁹ C.G. Wihlborg and P.M. Wijkman, "Outer Space Resources in Efficient and Equitable Use: New Frontiers and Old Principles", 24 *Journal of Law and Economics* 23-44 (1981) at 29.

'political' decisions, and the market mechanism, typically used to make 'economic' decisions.²⁰ By divorcing the interconnection of laws, markets and efficiency, Arrow shows a lack of appreciation of how 'political' decisions can directly influence 'economic' decisions. This is not uncommon.²¹

Once one accepts that markets operate on a set of legal norms, it seems logical to ask the questions: Which legal norms will promote efficiency and what steps can be taken to build efficient markets? To do this one must answer the question of how legal norms can be established in order to establish efficient markets. The analysis contained in this section shall be expanded upon in Chapter 2: Efficient Domestic Laws.

1. The Underlying Role of Legal Norms: Enforcement and Creation

As stated above, economic theory, and therefore efficiency, rests on the assumption of operational markets. Markets rest on a set of legal rules. The formation of efficient legal rules requires an efficient enforcement of the rules. Since governments which are bound by constitutional constraints generally have the ultimate final say over the creation and the enforcement of legal norms, they necessarily play a large role in determining whether efficiency can or will be achieved.

a. The Role of Contract Law

Markets are almost always based on a series of bilateral contracts. Contract law plays an important role in determining how the owners of property engage in mutually advantageous trade. Contracting involves an exchange of promises for either services or property rights. The most common exchange is where each party to the contract trades something of value in exchange for something else which has value. In Posner's view contract law has three functions. First, it maintains proper incentives for exchange, protecting the contracting parties from nonperformance and fraud. Second, through the establishment of a system of rules, it reduces complexities and transaction costs. Third, it helps the parties engage in more trade in the future, because a learning process takes place as people become more familiar with the rules and the procedure.²²

b. Enforcement of Legal Norms

Relative certainty is a prerequisite for an efficient market. Underlying all contractual arrangements is the notion that the promises which have been exchanged can somehow be ultimately enforced.²³ Enforcement can take many forms and does not even have to be certain for the market to operate. If enforcement is uncertain, this uncertainty must be considered a market risk. Even allowing that some uncertainty of enforcement is present in virtually every contract (the death or bankruptcy of one of the contracting parties or an act of God may prevent performance), an efficient market will be one in which the risk of nonperformance is minimized.

One way to lower uncertainty is by having an efficient enforcement mechanism.²⁴ Enforcement mechanisms can come in various forms. In addition to government sponsored court systems, enforcement can take place via private courts, arbitration or tribunal, social stigma or even the possibility of physical intimidation.

²⁰ K.J. Arrow, Social Choice and Individual Values (New Haven: Yale University Press, 1951) at 1.

²¹ Other examples of this omission and its consequence to the economics, public choice and law and economics fields are noted in the Appendix to this chapter.

²² R.A. Posner, Economic Analysis of Law, Third Edition, (Boston and Toronto: Little, Brown and Company, 1986).

²³ For a general discussion on the enforceability of contracts see R.A. Posner, *Ibid.* at 79-85, § 4.1; and G. Tullock, The Logic of the Law (New York: Basic Books, 1971) at 35-47.

²⁴ H. Demsetz, "The Exchange and Enforcement of Property Rights" in Efficiency, Competition and Policy: The Organization of Economic Activity Volume I (Oxford and Cambridge, MA: Basil Blackwell, 1990) 31-46.

The market for loan sharking (private loans at usurious rates) works despite the knowledge that the courts will not enforce contracts which are against public policy. The incidence of nonpayment may be very low, even without the ultimate protection of the courts, if the non-payer is relatively certain to be physically harmed. As there is reasonable certainty of enforcement, risk of non-repayment is low.

Physical intimidation may not even be necessary for a relative certainty of enforcement: the possibility of social stigma may be enough. Private gambling is a good example. If a bet between friends is made on a football match (a promise to pay by each party based on a condition), courts again will not enforce the contract if gambling is deemed to be against public policy. If being known as a "welsher" creates enough of a social stigma, the bet will usually be paid by the loser, the market will be relatively certain and efficient with corresponding low transaction costs.

Private courts, arbitrators and tribunals act on a different basis. Parties contract to use these alternatives to the court systems because they may be thought of as being cheaper, more certain or as having more expertise (all attributes of efficiency).²⁵ Underlying their effectiveness is the court system which will ultimately back the decisions of these alternatives, as long as this arrangement was bargained for in good faith and the alternative dispute resolution system followed its own legal procedures.

2. Efficient Enforcement and Creation of Legal Norms

Efficient enforcement of legal norms rests on having well defined and certain property rights. Certain and clear rights can be cheaply, quickly and consistently protected and enforced by the courts. This is a necessary precondition for having the lowest possible contracting and transaction costs.²⁶

a. Creation of Legal Norms

Governmental actions which include law making, taxation (a subset of law making), regulation, law and regulation enforcement and bureaucracy may seriously enhance or detract from every element of virtually any market. Governments therefore may either promote or detract from economic efficiency since their actions or inactions may directly or indirectly affect contracting, monitoring, transaction, agency and opportunity costs.

b. What is Efficient Law?

Efficient law is a set of legal norms which create markets that maximize satisfaction. Efficient law must, among other things, create conditions under which choices can be made rationally. Rational decision making is based on markets in which either the eventual outcome is certain or risk can be properly measured. An efficient legal system must therefore uphold the principles of certainty of outcome or certainty of risk in order to maximize satisfaction. As legal norms affect markets (and *vice versa*), only laws which will efficiently facilitate markets can be viewed as proper. Using this criterion the types of government action which can be viewed as proper are severely limited by some rational constraints. From these constraints, the circumstances under which governments should become involved in the market place can be limited. The creation of efficient law is somewhat separate from the issue of when governments should become involved in the market, for reasons which shall later become apparent. The creation of efficient domestic laws will be more fully discussed in Chapter 2; efficient laws in an international context are the focus of the second part of this book.

²⁵ This will be further discussed in Chapter 6.

²⁶ For a discussion of this see M.A. Crew and C. Tawit, "On the Efficiency of Law: A Public Choice Perspective", 66 *Public Choice* 15-36 (1990).

Section 4: Laws, Markets and Efficiency: When governments should become involved in markets

Laws can make markets more efficient. 1990 Nobel Prize Laureate Harry Markowitz recently explained why laws may be necessary to make markets more efficient: "[One] may think that markets can run themselves. This is not the case. Laws and law enforcement are needed to assure me that the meal I buy is not poisoned and the airplane that I fly on is well maintained; that those who manufacture things for my use pay their full costs, including the cost of cleaning up the mess they make; that if I deposit money with a bank or pay a premium to an insurance company the banker or the insurer will not go to Las Vegas to gamble with my money."²⁷

1991 Nobel Prize Laureate Ronald Coase outlined how and why the government is important to the market place.

"The government is, in a sense, a super-firm (but of a very special kind) since it is able to influence the use of the factors of production by administrative decision. But the ordinary firm is subject to checks in its operations because of the competition of other firms which might administer the same activities at lower cost, and also because there is the alternative of market transactions against organization within the firm if the administrative costs become too great. The government is able, if it wishes, to avoid the market altogether, which a firm can never do. The firm has to make agreements with the owners of the factors of production that it uses. Just as the government can conscript or seize property, so it can decree that factors of production should only be used in such-and-such a way. Such authorization methods save a lot of trouble (for those doing the organizing). Furthermore, the government has at its disposal the police and the other law enforcement agencies to make sure that its regulations are carried out."²⁸

Because the government can and often does act as a monopoly supplier of market rules, all of its actions will have an effect on satisfaction. Not all government actions will maximize satisfaction. As a result, some kinds of constraints must be placed on government actions. This section shall lay out precisely which types of governmental actions and expenditures can enhance efficiency. Every proposed government action or expenditure should be argued to have at least one of the purposes outlined below.

Since governments can either enhance or detract from market efficiency, the following question arises: When should governments become involved in markets? The usual answer, as in the examples given by Markowitz, is when markets fail or have the potential to fail.

Markets can fail in many ways. Each failure presents an opportunity for governments to facilitate and augment the market process. In the event of a market failure, the case for government intervention is strong in theory. Great care must, however, be taken that the cost of the intervention (either direct or indirect) is less than the amount of the benefit. As Coase stated: "All solutions have costs and there is no reason to suppose that government regulation is called for simply because the problem is not well handled by the market or the firm."²⁹ Although this is difficult to measure, there are only three instances in which it is efficient for the government to attempt to facilitate markets.

1. When the tax base is increased by more than the cost of the action.
2. When resources are inadequately priced by markets and the benefits from reallocating underpriced resources are greater than the cost of the action.
3. When societal satisfaction is increased more than the cost of the action.

²⁷ H.M. Markowitz, "Markets and Morality or Arbitrators Get No Respect", Wall Street Journal Europe (May 15, 1991) p. 8.

²⁸ R.H. Coase, "The Problem of Social Cost" (1961), Reprinted in The Law, The Market and The Firm (Chicago and London: University of Chicago Press, 1988). pp. 95-156 at 117.

²⁹ Ibid. at 118.

1. Increasing The Tax Base

The efficiency criterion will be satisfied if the size of the tax base is increased by more than the cost of the action. The tax base is not defined as what the government actually collects. It is the *capacity* of the government to tax if it needs or chooses to do so. The growth of the tax base does not have to be direct or even immediate to be efficient. When discussing a future government's need or desire to spend tax revenues, the issue of whether tax revenues are ever collected from the tax base is not important; only the option to do so is.³⁰

The reason why the amount of the increase in the tax base is an appropriate measurement of efficiency is that some types of government actions should be thought of as investments. An investment can only be justified if the investment is considered to have a positive net present value. Provided investments have a positive value they can be "cashed in" in the future, when or if needed. The decision to cash in on the investment is an issue separate to whether the investment should be made.

Of course, the efficiency of each particular expenditure must still be proven, and it must be shown that, in the absence of government action, non-governmental investment would be inadequate. Government expenditures for education, research and development and infrastructure are types of government expenditures which might be considered to be efficient under these criteria.

a. Education

Government expenditure for education would be efficient if the total amount of the following three potential revenue sources was directly or indirectly increased by more than the cost of the government expenditure. These potential revenue sources include: (1) the earning capacity of the students; (2) the value of the intellectual property developed; and (3) the direct and the indirect expansion of the earning capacity of the capital invested within the government's jurisdiction as a result of the students' additional knowledge and earning capacity.

³⁰ The Laffer curve presents an interesting illustration of the difference between the tax base and the government's ability to collect tax revenue.

On the graph there are three possible points at which the government may choose to tax. Obviously taxing at rate C makes little sense, as the government collects less revenue and alienates a number of potential taxpayers. The options are now narrowed to rates A or B. I would argue that taxing at rate A is almost always more appropriate than taxing at rate B. The reason for this is that at rate B the government is already collecting as much tax revenue as it possibly can. This leaves the government with no future option to raise additional revenue in case of a recession or national emergency. Since having a certain amount of flexibility is always important, rate A is more appropriate than rate B. This is why developing a tax base and collecting tax revenue should be thought of separately.

b. Research and Development

Government expenditure for research and development would be efficient if, as a result of the expenditure, the value of the research developed, the increased earning power of the scientists participating or benefiting from the research, and the earning capacity of the capital attracted as a result of the expenditure exceeded the net present value of the cost.

c. Infrastructure

Government expenditure for infrastructure is more complicated and contains more potential (and indirect) benefits. First, as infrastructure generally involves capital items, governments often have a better ability to either charge for usage or to sell (privatize) them. This alone may make investment in infrastructure efficient. Second, investment in infrastructure enhances the earning power of workers and capital. Third, investment in infrastructure may help attract or maintain investment. Fourth, investment in infrastructure may help augment another tax base.³¹ For example, the provision of roads, will help stimulate the demand for automobile ownership and usage. An investment in roads may therefore increase revenues in the form of road taxes, licence fees and gasoline taxes. If the collective earning capacity of all of these items exceeds the net present value of the cost of the infrastructure investment, the investment will be efficient.³²

2. Nonexclusive Resources and Negative Externalities

When the use of resources is nonexclusive or when negative externalities are present and uncompensated for, government action will be efficient when the benefits from government action exceeds its costs. There are at least three different categories of government actions which may be efficient under these circumstances. These include regulating or taxing the use of: (1) nonexclusive scarce resources, such as roads,³³ radio frequencies, fishing rights and the use of the skies by airplanes; (2) unpriced resources which are difficult to define, such as a "clean" environment; and (3) unpriced or underpriced actions or resources. Underpriced actions or resources are goods or activities where the market price does not reflect the entire cost of the resource or activity. Examples of unpriced or underpriced activities or resources include the environment, the creation of garbage and the use of tobacco and alcohol. Most types of government regulation, such as environmental controls, health and safety regulations, consumer protection and antitrust policies, attempt to address negative externalities and the underpricing of resources.

³¹ Robert Reich indicates the difficulty in measuring benefits. While not assessing whether any government expenditures are efficient, he does point out that investment in education and infrastructure is a dynamic process when he refers to the "spillovers" which occur as a result of corporate investment. He indicates that "spillovers might include the jobs that result from having sophisticated factories, laboratories, and equipment in the United States, whose high wages multiply throughout the economy, raising other incomes. Good jobs generate higher tax receipts, which permit governments to invest in public facilities such as improved schools and transportation and also care for the elderly and the disadvantaged in society. Moreover, on-the-job training and the resulting technical know-how enables Americans to innovate and thus generate more wealth for the United States in the years to come." R.B. Reich, "Who is Them?" 69 *Harvard Business Review* 77-88 (March/April 1991) at 83.

³² The pollution caused by cars ought to be taxed separately in order to ensure that the creation of the pollution (and other negative externalities such as noise) are fully levied. This is further discussed below.

³³ Scarce road space will be increasingly priced as technology makes it more feasible. Following the lead of Hong Kong (a plan which was later abandoned) and Singapore, the London borough of Richmond will be experimenting with an electronic pay-as-you-go system to see whether road pricing relieves traffic congestion. Initially only the 100 council owned automobiles will be monitored. R. Tomkins, "London to Test System for Pay-As-You-Drive Roads", *Financial Times* (September 18, 1991) p. 16. Also see R. Tomkins, "Clocking Up the Miles", *Financial Times* (September 18, 1991) p. 10.

a. Nonexclusive Resources

For some resources, in the absence of government regulation, markets will not necessarily allocate the resources optimally.³⁴ This might happen when the use of the resources is nonexclusive.

Since usage is nonexclusive, everyone may use the scarce resources free of charge. This may lead to over-use to the extent that the value of the resource eventually is worth little to anyone. For example, if waters are over-fished (since the right to fish is not regulated) individually rational fishermen may fish during spawning season and will deplete the number of fish in the waters to the overall long-term detriment of society (and perhaps the fishermen themselves). Individual rationality without cooperation or collective action may lead to diminished long-term societal satisfaction. Since nonexclusive common property resources are difficult to allocate, some type of collective action is required both to define the rights and to maximize their long term value. The Coase Theorem states that by attaching property rights to resources they become more valuable.³⁵ If regulation increases the value of the resource by more than the cost of the action, government intervention is efficient.³⁶

b. Negative Externalities

Certain activities and products have negative externalities or spillover effects. An externality exists when the producer or consumer of a good or service passes on uncompensated costs or benefits to others. If activities have a negative effect on others and those effected have little or no practical recourse to stop or be compensated for such actions, the products or activities are underpriced by the market (the externalities are not internalized).³⁷

c. The Environment

The environment is the classic example of an underpriced asset. A clean environment is a scarce resource. As no individual "owns" the environment, it can be used at virtually no cost. This leads to overproduction of polluting activities. Overproduction is due to insufficient pricing. Therefore, in order to maximize societal satisfaction, government action may be necessary.³⁸ If regulation decreases the value of the harm caused to the environment by more than the cost of the action, government intervention is efficient. Taxes can also be used

³⁴ These are referred to as collective goods or common property resources. Since usage is non-exclusive, economists predict that there will be difficulty in collecting tax revenue for the use of collective goods since people have an incentive to sit back and let others pay for the public goods, while they enjoy the benefits without charge. Non-payers are referred to as "free riders." As a rule, the smaller the group benefiting from a public good the easier it is to organize a group to provide the service. The logic behind the government providing public services is that the government has the ability to tax and the power to coerce payment of taxes. M. Olson, *The Logic of Collective Action* (Cambridge: Harvard University Press, 1971).

³⁵ Supra note 28.

³⁶ For an excellent discussion of non-exclusive resources and common property see Wihlborg and Wijkman, supra note 19. For a background and an explanation of the Coase Theorem see J.L. Coleman, "The Economic Analysis of the Law" in *Ethics, Economics, and the Law*, J.R. Pennock and J.W. Chapman (eds.), (New York and London: New York University Press, 1982) at 83-103.

³⁷ For an excellent discussion on the economics of consumer protection see H. Beales, R. Craswell and S.C. Salop, "The Efficient Regulation of Consumer Information", 24 *Journal of Law and Economics* 491-544 (1981).

³⁸ R.D. Morganstern makes this point well in "Towards a Comprehensive Approach to Global Climate Change Mitigation." "The goal of policy making is to design an efficient climate change mitigation strategy that maximizes (under uncertainty) overall welfare, including measured GDP and the value of nonmarket goods and services ('Green GNP')." 81 *American Economic Review* 140-145 (1991) at p. 140.

either to more fully cost output through an effluent charge levy, or for activity prevention purposes. In various countries one sees the use of taxes, such as deposit charges for bottles, cans, cars and batteries, to discourage or more fully cost a wide variety of activities.

d. Tobacco, Alcohol and Health and Safety

Individual use and abuse of tobacco and alcohol, as well as endangering one's own health and safety, increases society's medical costs. This increased cost is reflected in insurance costs or in government health spending, depending on how the health care system is organized and financed. Individual assumptions of known risks should be considered negative externalities since the people who did not use the alcohol or tobacco and those who were more careful bear at least part of the resulting cost of the actions. This feature of externalities makes them candidates for government regulation and taxation.³⁹ Government action is efficient if the cost of the action is less than the societal cost.

On the basis of social costs, one can argue that motorists should use seat belts, motorcyclists wear helmets, smokers stop smoking, and that people not drink excessively, drink and drive, or have unsafe sex. Most people assume that only the victim is hurt in the event of an accident or an individually preventable illness. This is clearly mistaken. As long as there is a shared insurance pool or national health insurance, the costs of treatment and hospitalization are largely borne by the "non-victims."⁴⁰ Since they bear a larger part of the medical costs, the taxpayers or insurance pool should have the right to impose measures which may lower their own taxes or premiums. Those who prefer to engage in individually dangerous behaviour may be allowed to do so, but only upon posting a bond which is considered large enough to cover the full additional costs of their behaviour. This could come in the form of additional insurance coverage.

3. Cost and Satisfaction

Efficiency will occur if satisfaction is increased by more than the cost of the action. This final category is perhaps overly broad, but the types of government actions which fall under this category can be limited to the provision of defence, policing, justice, social security, health care and income redistribution.

a. Defence, Policing and Justice

Defence, policing and a system of justice are necessary to insure peace of mind and a sense of order. All three could have been considered above as a form of "infrastructure," in the sense that they collectively reduce risk and may have a large and potential quantifiable effect on whether investment is made or maintained within a jurisdiction. They are listed separately since a large part of their benefit is derived from community satisfaction, which cannot be directly quantified. All three should be provided to the point at which the marginal amount of aggregate satisfaction provided exceeds the marginal cost.⁴¹

³⁹ The head of the German Doctors' Association has indicated that obese people should carry the full weight of their health costs by paying a "kilogram premium" for every kilogram of excess weight that they carry. Karsten Vilmar stated: "I don't see why some people can behave unreasonably without thought of the consequences and then burden the community with the results." His proposed remedy is to levy some special taxes on sweets, tobacco and alcohol to discourage consumption and to help pay for the medical consequences of their abuse. "Obese Should Carry Weight of Health Costs, Official Says", *Wall Street Journal Europe* (July 18, 1991) p. 2.

⁴⁰ When the costs of one's actions are largely imposed on others, this is referred to as a "moral hazard."

⁴¹ Given the common perception that public goods must be provided for by government, it may come as some surprise that a group of 2,550 downtown Philadelphia property owners, have been able to organize and maintain their own private 'government.' The private 'government' provides sanitation, security and other public services. There is an 80 square block area where public streets had been ill-kept and dangerous. This under-provision of "public services" in "Filthadelphia" had the effect of significantly lowering property values. Many former customers had abandoned downtown shopping in favour of

b. Income Redistribution, Social Security and Health Care

Programs which redistribute income, provide pensions and mandate the provision of health care may increase societal satisfaction. As all three programmes necessarily take money away from people who would not voluntarily contribute to the funding of the programmes, they are not Pareto efficient. The provision of these programmes is only efficient to the extent that satisfaction is maximized.⁴²

Section 5: Conclusion

Markets are based on legal norms. Markets may or may not be efficient. Laws can either promote or detract from efficiency. Efficient law begets efficient markets. The circle is complete. While laws, markets and efficiency should be thought of simultaneously they rarely are. If one accepts that laws effect markets and that the goal of public policy should be to maximize societal satisfaction, one must also accept that efficient laws and public policy can only be those which make markets more efficient. This understanding of a market of something constructed within a set of laws contrasts with the models used in most economic analyses.

Politicians and other public servants understand that public policy is mostly about changing the underlying market conditions: either reallocating economic opportunities or redistributing economic advantage.⁴³ Changing underlying market conditions cannot be a legitimate end in itself. The self-interest of politicians and bureaucrats and rent-seeking cannot generally be viewed as efficient.⁴⁴ If government actions cannot be justified on one of the three grounds outlined above the proposed government action cannot be judged to be efficient. Inefficient

cleaner and safer suburban malls. Appeals to the city for better services were unheeded because of a budgetary crisis. The downtown property owners decided to form their own 'government.' They hired more than 100 street cleaners and forty "community service representatives", who have duties similar to policemen, namely to patrol the streets. The property owners, who are already heavily taxed by the city, pay money into their district 'government' which answers to the property owners, not to voters or residents. Unlike the city government, the district 'government' has had no problem collecting taxes. More American districts are currently providing or considering providing public goods on the same basis. D. Russakoff, "In Philadelphia, a Private Government Cleans Up", International Herald Tribune (September 20, 1991) p. 1. The property owners have undoubtedly undertaken this action because the benefits of providing sanitation and additional policing outweigh the costs. One would expect that property values and rents have been increased by more than the net present value of the tax levied to finance the additional services.

⁴² Some people in some places may suffer using this calculation. The better examples may come from the field of health care. Under this criterion, health care rationing is optimal if the cost of a procedure is greater than the aggregate benefit. For example, if a heart transplant operation would marginally benefit the recipient, but cost the rest of society a great deal of money, overall satisfaction might well be reduced if the operation took place. But a full calculation would also have to consider the satisfaction of knowing - through one's life - that if a heart transplant offered even marginal benefits, it would be available. This satisfaction gained from the provision of general security may be more significant than the benefits of the procedure itself.

⁴³ D.W. Bromley, Economic Interests and Institutions: The Conceptual Foundations of Public Policy (Oxford: Basil Blackwell, 1989).

⁴⁴ An exception may lie when special interests are trying to obtain valuable property rights. For example: (1) Drug manufacturers who lobby the government for better or longer patent protection in order to legally enforce their monopoly position will have a greater incentive to invest in the development of valuable medicines; (2) The granting of prestigious honours and titles to individuals who act in the public interest will give individuals the incentive to take actions which help others or enrich society.

government action decreases satisfaction. A decrease in satisfaction occurs only because the markets are made inefficient by creating non-optimal opportunity costs.

The field of law and economics should clearly and directly focus on the interrelationship between laws, markets and efficiency. If one recognizes from the outset that the goal of government should be to optimize satisfaction, an emphasis on this interrelationship might lead to a proper discussion of the importance which laws have on markets. This approach should lead to a measurement of the true costs and benefits which a proposed law may impose. The manner in which satisfaction is optimized should be the focus of public choice; the drafting of the results of this public choice question should be in the realm of law and economics. Another circle is completed.

Pigou perhaps understood this relationship between laws, markets and efficiency best. He stated that the goal should be "to ascertain how far the free play of self-interest, acting under the existing legal system, tends to distribute the country's resources in the way most favorable to the production of a large national dividend, and how far it is feasible for State action to improve upon 'natural' tendencies."⁴⁵

⁴⁵ *Supra* note 15 at 183.

Appendix: Consequences of Efficiency Being Ill-Defined

Efficiency has often been ill-defined in the fields of law and economics, institutional law and economics and public choice. The reason for this is that there has not been a fundamental understanding of how laws, markets and efficiency interrelate. This has had negative effects on the reasoning given by many prominent lawyers, economists and political scientists. Since legislators, regulators, judges and bureaucrats all have the power to change market conditions and institutions through laws, regulations, interpretations and actions or inaction, it is somewhat surprising how often this relationship is misunderstood. The following paragraphs will briefly discuss how the concept of "efficiency" has been misused in these fields, and why this usage was incorrect.

I. Law and Economics

Mercuro said that efficiency is "the cornerstone of law and economics." The Chicago-Virginia school of law and economics uses economic efficiency as the primary or only criterion to analyze political, legal and economic issues in order to formulate legal and economic policy.⁴⁶ While this notion is fundamentally correct, it only makes sense to use efficiency criteria if efficiency is properly defined. A Posnerian view of efficiency relies heavily on Pareto efficiency. Posner, in addition to using Pareto criteria as a basis for efficiency criteria, also uses efficiency and 'wealth maximization' criteria interchangeably.⁴⁷ More importantly for this book's purposes he seems to divide law into (1) what the courts do in enforcing law and (2) what public institutions do in making law. Posner believes that practitioners, through their attempts to determine which legal structures are correct, engage in an efficiency enhancing process. Efficient political and legal institutions are believed to emerge, out of these attempts.⁴⁸ This is an inadequate definition of efficiency for the reasons given in Chapter 1.

Posner concedes that using efficiency as a synonym for wealth maximization is insufficient. He states that "more efficient is not a synonym for 'better'"⁴⁹ and recognizes that this notion of efficiency is "a theory that the law seeks to optimize the use and exchange of whatever rights people start out with."⁵⁰ In Economic Analysis of the Law, Posner, in discussing why restrictive covenants (i.e. prohibiting the sale of property to persons of a certain race or religion) are not legally enforceable, states that: "The legal source of the policy against private racial discrimination, [is] a policy founded on distributive rather than efficiency notions." He goes on to say:

The major ethical approach posed by an efficiency approach to the common law is not the occasional discrepancy between an economically derived ethical scheme and the traditional ethics of an everyday life, but the discrepancy between efficiency maximization and notions of the just distribution of wealth. In a market economy where the role of law, and of government generally, is just to control externalities and reduce transaction costs - which is basically all the law and government that economic efficiency requires - differences in people's tastes, abilities, and luck may generate substantial inequalities in the distribution of income and wealth....[The] law is, for the most part, distributively neutral....Even a thoroughgoing utilitarian, however, might approve a division of labor in government whereby the courts in elaborating common

⁴⁶ N. Mercuro, "Toward a Comparative Institutional Approach to the Study of Law and Economics", in N. Mercuro (ed.), Law and Economics (Boston: Kluwer, 1989) at 18-22.

⁴⁷ R.A. Posner, The Economics of Justice (Cambridge: Harvard University Press, 1981) at vii and 88.

⁴⁸ See R.A. Posner, Economic Analysis of Law, Third Edition, (Boston and Toronto: Little, Brown and Company, 1986); R.A. Posner, The Federal Courts: Crisis and Reform (Cambridge: Harvard University Press, 1985); and R.A. Posner, "The Law and Economics Movement", 76 American Economic Review 1-13 (1986).

⁴⁹ R.A. Posner, "Economic Justice and the Economist", 33 Public Interest 109-113 (1982) at 113.

⁵⁰ R.A. Posner, "Utilitarianism, Economics, and Legal Theory", 8 Journal of Legal Studies 103-140 (1980) at 108.

law principles confined their attention to efficiency, while taxing and spending branches of government, with their greater capacity for redistributing wealth cheaply and effectively, concentrated on redistribution.⁵¹

A proper definition of efficiency inherently includes notions of distribution and, what is more important, it sees a greater role for regulators and legislatures to enact efficient laws. The courts should merely interpret the laws. Societies pay regulators and legislatures to make distributional and economic decisions. It is also difficult to see how Posner can ignore the effect which the act of taxation has on income distribution and efficiency.

One should also note that laws which prohibit the sale of property to certain classes of people have an effect on the market (which is negative overall). One could argue on pure Pareto efficiency grounds that a prohibition of Pareto exchanges, which leaves both the buyer and the seller worse off for not having made trades, that they would have made if the law did not exist, is by definition Pareto inefficient.

Posner's approach towards efficiency is questioned elsewhere. As Burrows and Veljanovski state, the aim of wealth maximization misses a major point: "A disappointing feature of the economic approach to the law today has been the tendency of many studies to ignore the relationship between *social efficiency* and the distribution of wealth and income."⁵² The limitations of Pareto efficiency as used by the Chicago-Virginia school are best explained by Mercurio, Rowley and Ulen. Mercurio states that: "Such attempts are extremely useful in describing the efficiency of resource allocation generated through Pareto-structured institutions, in the sense of logical positivism. However, there is no basis to claim that such institutions are 'appropriate.' ... much of the Chicago-Virginia literature appears purposely narrow (some might say conservative) both in form and substance.... much of the Chicago-Virginia approach is less open, less realistic, and consequently less informative."⁵³

Rowley, while criticizing Posner's approach to efficiency, does not define efficiency himself. "Though Posner is forceful in projecting the efficiency hypothesis, he is less forthright in explaining the mechanism through which common law efficiency emerges, relying instead upon the as-if methodology of the Chicago school. Although judges, in his analysis, are perceived to be independent from the legislature, this does not explain why they should show special malleability when confronted with arguments for efficiency."⁵⁴

The consequences of not having a proper definition of efficiency are illustrated by Ulen, when he discusses what are settled issues and open questions for law and economics.

"One topic in law and economics about which we should suspend debate and simply agree to disagree is the controversy about whether the law is or should be concerned principally with economic efficiency or with justice. The law, like many of us, can serve two functions simultaneously and well: it can promote the efficient use of resources while at the same time serving to do justice. There is no necessary mutual exclusivity between these goals. And, happily, efficiency and justice frequently argue for the same legal rule. For example, I believe that specific performance is not only the fairest remedy for breach of contract but is also the most efficient. Similarly, comparative negligence is not only fair; it is also efficient. I am not suggesting the Pollyanna-ish conclusion that there are no real conflicts between efficiency and fairness. In fact, there are: to take an example, consider product liability. There, I believe, an attempt to be fair to victims of product-related harms has led to a great deal of inefficiency (in

⁵¹ Ibid. at 240-241.

⁵² P. Burrows and C.G. Veljanovski, The Economic Approach to Law (London: Butterworths, 1981) p. 12.

⁵³ Supra note 1 at 18-19.

⁵⁴ C.K. Rowley, "Public Choice and Economic Analysis of Law" in N. Mercurio (ed.), Law and Economics (Boston: Kluwer, 1989), pp. 132-148 at 138. Rowley at 132 also points out that Posner uses the word efficiency to indicate wealth maximization.

the sense that several valuable and safe products are in short supply, unavailable, or excessively expensive). In that area, as well as others in which efficiency and fairness are at odds, a trade-off is called for. The most an economist can do in that situation is point out the *efficiency* and, where economic analysis allows, the *equity* consequences of different legal rules, and then let political pressures and judgements decide what to do. (How those trade-offs are resolved is part political science, part public choice economics, and part critical legal studies.)⁵⁵

This shows that Ulen, while correct in his dismissal of Posner, as well as many of the others engaged in Law and Economics, does not seem to understand the relationship between laws, markets and efficiency. In an efficient market no good would be either in "short supply, unavailable or excessively expensive": it would be properly priced to reflect its full cost. When the market is indeed efficient, satisfaction will be maximized and the market will always be properly supplied.⁵⁶ If the market is efficient, efficiency (as described by Ulen) and justice will always occur simultaneously.

Warren Samuels, when discussing the interrelationship between the legal and economic processes, focuses on relative rights and power in the law-making process and in the market.⁵⁷ He does not however impose his own value judgements by using value-laden terms such as "justice" nor does he use terms like "efficiency," to demonstrate that the golden rule often applies to both the economic and legal process: He who has the gold makes the rules. If the golden rule applies, those who have the gold will work either to maximize their position, or if they are risk averse, to preserve their advantage.⁵⁸ Whether this process is efficient is a separate issue. The process should be evaluated to determine whether aggregate satisfaction is optimized. This will be discussed more fully below.

II. Institutional Law and Economics

In a survey of institutional law and economics (ILE), Schmid states: "Efficiency for whom is a central question for ILE."⁵⁹ This question is fundamentally incorrect. The response demonstrates that the questioner does not understand the difference between efficiency and personal or group maximization.

The concept of efficiency has three elements: the end goal of an efficient system, the process of achieving efficiency, and the starting point. Life is not fair. Since the starting point is constantly changing, one should not assume that the starting point itself is (or necessarily should be) efficient. From an inefficient starting point, an efficient market must have measures which create an efficient process and ending point. As Rowley states: "as Paretian welfare economics indicates, there is an infinite number of efficiency outcomes, each related to a specific prior distribution."⁶⁰ An efficient process will correctly price resources and an efficient ending point will be where societal satisfaction is maximized. Even if the available goods and services remain static, over time individuals change how they subjectively value scarce resources.

⁵⁵ T.S. Ulen, "Law and Economics: Settled Issues and Open Questions", in N. Mercuro (ed.), Law and Economics (Boston: Kluwer, 1989) pp. 219-248 at 223.

⁵⁶ Efficient legal structures are described in Section 3.1 of Chapter 1.

⁵⁷ W.J. Samuels, "Interrelations Between Legal and Economic Processes", 14 Journal of Law and Economics 435-450 (1971).

⁵⁸ If the political machinery were to be used either to maximize or preserve wealth, this would be considered to be "rent-seeking."

⁵⁹ A.A. Schmid, "Institutional Law and Economics: A Survey", Staff Paper No. 91-27, Michigan State University (April 1991) at 3. This definition is also used by U. Pagano, "Property Rights Equilibrium and Institutional Stability", in J. Backhaus (ed.), Systemwandel und Reform in Östlichen Wirtschaften (Marburg: Metropolis, 1991), pp. 185-224 at 185-6.

⁶⁰ *Supra* note 9 at 132.

If resources are scarce and have value, most individuals will want more of them. If and when scarce resources end up in the hands of the persons who place the highest value on them, one should not say that the market is inefficient for those who did not value them so highly. Assuming that this process was fair (efficient) and the goods were properly priced, one should note that each individual did not necessarily "win" at the expense of another. The process could not have been "efficient" for only a limited number of parties. It was efficient for everybody: the market worked.⁶¹ While everyone would like to have an unlimited amount of resources at his disposal, the fact remains that resources are scarce and need to be allocated.

If Schmid had stated that 'to whom (as opposed to for whom) efficiency is a central question for ILE,' he would be standing on firmer ground. The to whom question logically seems to be a pure public choice question. While one cannot dispute that properly priced resources should be the goal of laws and markets, one can certainly disagree as to what prices will lead to optimal allocation and which distribution will maximize societal satisfaction. In a democracy, politicians, regulators and bureaucrats are hired to determine this, or more precisely, to determine the market rules which will ensure this outcome. Ideally if they do not do this they should be fired or replaced. The fact that they are rarely replaced and do not always lead markets to properly price scarce resources does not mean that they were not hired in order to have been engaged in this process.

The use of efficiency-based analytical concepts will necessarily have a winner and one or more losers. It is therefore difficult to see how efficient institutions could ever be formed, except by luck or accident. A more useful suggestion is that over time, democratic societies should enact laws and market rules where exchanges take place and tax policies are enacted where the amount of satisfaction accruing to the "winners" would greatly outweigh the satisfaction lost by the "losers." Moreover, if the rules and policies are impartial, through hard work or superior skills, today's "losers" will have real chances at becoming tomorrow's "winners" and today's "winners" will become tomorrow's "losers" if they are lazy or careless.

III. Public Choice

"Public choice applies economics' methods to politics, and, in particular, to two central problems: the collective action problem and the particular problem of aggregating preferences."⁶² "The encroachment of economics upon politics is not difficult to understand. Being political is viewed by experts as bad, while being economical is acclaimed as good."⁶³ This book's definition of efficiency covers both of the central public choice problems: collective action (in the form of correctly pricing inputs and outputs) and aggregating preferences (maximizing societal satisfaction). It is curious that the profession does not address the issue of efficiency in this context.⁶⁴

As stated above, the question of "efficient to whom" is the most valid question facing public choice economists. Unfortunately, since few public choice economists analyze the efficiency (in the way it was defined in Chapter 1) of markets to see whether inputs are properly priced or whether public satisfaction is maximized, this question is rarely discussed. Since public choice does not view efficiency in this way, the pricing of resources seems to

⁶¹ Not every economist would agree with this assertion. The Marxist economist Allen Buchanan also uses Pareto Efficiency as his standard. He argues that economists assume that Pareto Optimality and Pareto Superiority are either morally neutral or based on utilitarianism as the correct moral theory. He believes that this is a mistake. See *Ethics, Efficiency and the Market* (Oxford: Clarendon Press, 1985) at 13.

⁶² I. McLean, *Public Choice: An Introduction*, (Oxford and New York: Basil Blackwell, 1987) at 9. McLean oddly enough does not use any concept or definition of efficiency in this volume. Moreover He states at page 18 that: "The market is a residual category".

⁶³ A. Wildavsky, "The Political Economy of Efficiency", 8 *Public Interest* 30-48 (1967) at 48.

⁶⁴ R.B. Morton comes the closest. In "An Analysis of Legislative Inefficiency and Ideological Behaviour", 69 *Public Choice* 211-222 (1991), she defines "legislative inefficiency." "Legislative inefficiency occurs when the level of representation provided to a district does not maximize the social welfare of all constituents within the district." I would argue that while she is fundamentally correct, it would be better if legislators were to work toward maximizing more than a single district's social welfare.

be almost entirely in the realm of public finance and increasingly in the domain of environmental, transportation, health care and agricultural economics. The goal of maximizing utility seems to be concentrated in welfare and labour economics.⁶⁵ This seems to be an anomaly: by definition it should be at the centre of public choice analysis.

Even where efficiency is used to explain markets in a social welfare context, the efficiency described is often Pareto efficiency.⁶⁶ Other public choice theorists use different definitions of efficiency. For example, Scully uses a Pareto definition along with a macroeconomic definition of efficiency when a broader definition is more appropriate.⁶⁷ Pelzman asks whether all available information is in the marketplace.⁶⁸ Lee, Pasour, Wyckoff and Formby, Keeler and Thistle all define efficiency as allocative or X-(in)efficiency.⁶⁹

The other common public choice definition of efficiency stems from a cost-benefit approach to public choice. There is nothing inherently wrong with this approach if both (full) costs and benefits (in terms of optimizing societal satisfaction) are taken into account. This is rarely done.⁷⁰ More commonly efficiency is thought of in the term enunciated by Tullock: efficient rent-seeking.⁷¹ In determining what is efficient rent-seeking, Tullock measures whether the level of economic rents outweighs the costs of obtaining them. He in no way advocates that this process is efficient for the economy as a whole. Schwartz-Shea and Simmons, however, discuss the conflict between rent-seeking and macro-efficiency.⁷²

⁶⁵ J.W. Chapman and J.R. Pennock, Markets and Justice (New York: New York University Press, 1989). is an example of a book which applies a narrow definition of efficiency which would fundamentally have to change its analysis and targets when discussing inequity, if my definition of efficiency were used.

⁶⁶ J. Bonner, Politics, Economics & Welfare (Brighton: Wheatsheaf, 1986).

⁶⁷ For a Pareto definition see G.W. Scully, "Rights, Equity and Economic Efficiency", 68 Public Choice 195-215 (1991). Earlier, however, Scully used technical efficiency as a yardstick in "The Size of the State, Economic Growth and the Efficient Utilization of National Resources", 63 Public Choice 149-164 (1989). In this article at 154-55, his defence of transfer payments merits notice: "Too much income inequality may create incentives for the low income types to seek another social order. Redistributions may reduce work incentives, but may be an inexpensive (efficient) means of preserving the social order".

⁶⁸ S. Pelzman, "How Efficient is the Voting Market?" 33 Journal of Law and Economics 27-44 (1990).

⁶⁹ D.R. Lee, "The Trade-off Between Equality and Efficiency: Short-Run Politics and Long-Run Realities", 53 Public Choice 149-165 (1987); E.C. Pasour, Jr., "Non-Conventional Costs of Rent-Seeking: X-Inefficiency in the Political Process", 63 Public Choice 87-92 (1989); P.G. Wyckoff, "Bureaucracy, Inefficiency, and Time", 67 Public Choice 169-179 (1990); and J.P. Formby, J.P. Keeler and P.D. Thistle, "X-Efficiency, Rent-Seeking and Social Costs", 57 Public Choice 115-126 (1988).

⁷⁰ A recent exception can be found in A.A. Schmid, Benefit-Cost Analysis. A Political Economy Approach (Boulder: Westview Press, 1989).

⁷¹ G. Tullock, "Efficient Rent-Seeking", in J. Buchanan, R. Tollison and G. Tullock (Eds.), Toward a Theory of the Rent-Seeking Society (College Station: Texas A&M Press, 1980) pp. 97-112. This idea has been the inspiration to numerous papers, most recently: E.L. Millner and M.D. Pratt, "An Experimental Investigation of Efficient Rent-Seeking", 69 Public Choice 69-80 (1991); C. Paul and A. White, "Efficient Rent-Seeking Under Varying Cost Structures", 64 Public Choice 279-290 (1990); and J.F. Shogren and K.H. Baik, "Reexamining Efficient Rent-Seeking in Laboratory Markets", 69 Public Choice 69-80 (1991).

⁷² P. Schwartz-Shea and R.T. Simmons, "The Layered Prisoners' Dilemma: In Group Versus Macro-Efficiency", 65 Public Choice 61-83 (1990).

Chapter 2: Efficient Domestic Commercial Law

Abstract

Efficient law is a set of legal norms which create markets that maximize satisfaction. Efficient law must create conditions under which rational choices can be made. Totally rational decision making is based on markets in which either the eventual outcome is certain or where risk can be properly measured. An efficient legal system must therefore offer certainty of outcome or certainty of risk in order to maximize satisfaction. This chapter divides law into two categories: laws which directly involve the government and laws which apply to the citizenry. The laws which apply to the citizenry will be called background law. As virtually all commercial law falls under this category, this chapter explores which types of commercial laws will be efficient. Efficient commercial laws are those which fulfil certain necessary conditions namely: transaction and agency costs minimization, surety of outcome and aggregate satisfaction maximization.

Chapter 2: Efficient Domestic Commercial Law

"In the life of a nation, few ideas are more dangerous than good solutions to the wrong problems."⁷³

If the end of efficient law is clearly to maximize satisfaction, the means to achieve efficiency are a little less clear. The most fundamental means is to create markets where rational choices can be made. Rational decisions can only be made in markets where either the eventual outcome is certain or where risk can be properly measured. An efficient legal system must therefore provide certainty of outcome or reasonable certainty of risk measurement.

Besides creating a system in which risk can be measured with some degree of accuracy, efficient laws must also minimize transaction and agency costs. In purely economic terms, minimization of transaction and agency costs and maximization of the certainty of outcome may be thought of as the only goals to be considered in evaluating what types of laws are efficient. This is insufficient. Minimizing transaction and agency costs may conflict with the goal of maximizing aggregate satisfaction. An efficient law in a purely domestic context must have the sole goal of maximizing societal satisfaction.

This chapter aims to discuss in general terms how to ascertain what is efficient domestic commercial law. More specific details as to how each country may achieve the ends outlined in this chapter will be developed in chapters 3 and 4, when the concept of a national economic style is developed. Chapters 5, 6 and 7 will extend the concept of efficient domestic commercial law to the international arena.

Since the difference between efficient domestic law and efficient law in an international context may not be clear, an example of the differences is in order before expanding upon the elements of efficient domestic law.

With North Korea, Kampuchea, Albania and Myanmar (Burma) having rejoined the international community to various extents, no country attempts to be entirely self-sufficient. What these countries may be finding is that for all the benefits of openness there are some costs. International competitive pressures sometimes conflict with the domestic goal of maximizing domestic aggregate satisfaction. Countries should acquiesce to international pressure if the benefits of compliance are greater than the costs (in terms of aggregate satisfaction).

As an example, let us analyze an example of one international trade conflict: the Japanese distribution system. Japan has a retail distribution system which by consensus does not produce the lowest possible agency or transaction costs. This distribution system leads to less consumer choice, higher consumer prices and very small stores.

This is not to say that the system does not maximize aggregate satisfaction. It may. This is possible because these tiny neighbourhood stores provide customers with family owned stores offering continuity, excellent customer service, a place to keep up with the neighbourhood gossip, and credit facilities. In times of sickness or disability they will provide delivery; in times of family joy or tragedy there are always gifts; in times of hardship there is long-term unsecured credit. If this distributional coalition were to be broken up, a very large number of these stores would be forced to close, as some customers would want to shop for at least some of their requirements at large stores with lower prices. The new larger stores would be unlikely to provide the same degree or range of customer services. This loss of customer service may adversely effect a large number of people. Despite the high costs of maintaining this system, the present system would be efficient if there was no possible market structure which provided higher net aggregate benefits.

This system has the additional consequence of making it exceedingly difficult for new products to be introduced to these small stores. Many of Japan's trading partners run large trade deficits with Japan. Many foreign companies would like to sell their consumer products in Japan's small stores. This is difficult because of the stores' small size and because the established distribution system is largely tied to large Japanese manufacturers.

⁷³ R.B. Reich, *The Work of Nations* (New York: Alfred A. Knopf) at 243.

The introduction of a product in Japan by a new market participant requires that the participant either build his own distribution system or form a joint venture with a company with an established distribution system.

Should Foreign and Trade Ministries of various countries, in acting as champions for their domestic companies, inform the Japanese government, that if the distribution system is not changed and opened up for more direct foreign competition, the export of Japanese consumer goods into their countries will be limited, the Japanese government would be faced with a difficult public choice. Assuming that the established system is efficient, Japan must now weigh losing efficiency in the retail sector against losing exports.⁷⁴ Maximizing aggregate satisfaction in this context calls for a trade-off. Japan will now enter into negotiations. An efficient outcome for Japan will be the combination of results which lead to sacrificing the least amount of aggregate satisfaction (ending up with the highest amount of aggregate satisfaction possible). This may be the reason why bilateral negotiations with the United States or the European Community have led to elimination of "trade barriers" only at the margins of the market. They have not yet led to a complete overhaul of the system, even though some economists and politicians proclaim that Japanese (technical) efficiency and productivity would be improved by the market liberalization.⁷⁵ The international aspects of competition and efficiency will be elaborated on further in the second part of this book.

This chapter divides law into two categories: laws which directly involve the government and laws which apply to the citizenry. The laws which apply to the citizenry shall be called "background law"⁷⁶ for this book's purpose. The final section describes ways of measuring whether laws are efficient. Laws will be deemed efficient if they maximize satisfaction and minimize transaction and agency costs. As virtually all commercial laws are types of background law, this chapter explores which types of commercial laws will be efficient.

⁷⁴ Naohiro Amaya, a former senior official at the Japanese Ministry of International Trade and Industry, expresses this trade-off well (in a slightly different context) in D. Halberstam, *The Reckoning* (New York: William Morrow and Co., 1986) at 33. "If Japan pushed even harder with exports, then it was likely to cross the line between what was healthy for Japan economically and what was dangerous for Japan politically."

⁷⁵ T. Sakaiya, "...While Japanese Consumers Pay the Price", *Wall Street Journal Europe* (October 3, 1991) p. 6.

⁷⁶ The term "background law" comes from F.I. Michelman, "Constitutions, Statutes, and the Theory of Efficient Adjudication", 9 *Journal of Legal Studies* 431-461 (1980). In the article he divides law into three categories which operate at two levels. At the ground or constitutive level are institutional rules which frame two categories of law making activity at the second or regulatory level. In the foreground are statutory deal law which is worked out periodically between interest groups and legislatures and later applied by common law judges. In the background are residual regulatory laws passed by the legislature, which are continually and incrementally adjusted by common law judges. On theoretical ground, I accept this division of laws. In my analysis, it makes little difference whether deal law is made by judges, legislatures or regulators who develop the law or make the law more efficient. In the context of Michelman, I have merged background law and statutory deal law together. In my scheme of the law, the first level is the constitution which sets out the limits of governmental, individual or group power. At the second level, there are legitimate laws and regulations, including statutory deals, which help to efficiently regulate the market. If these laws are both legitimate and necessary, the laws are efficient. As stated in Chapter 1, laws which reduce satisfaction, including most laws passed for rent-seeking reasons, are not justifiable. One should note, however, that all statutory deals are not created solely as the result of rent-seeking. Statutory deals in the fields of technical or environmental standards may be necessary when virtually all of the technical information needed to establish efficient standards and regulation are in the hands of the industry being regulated. For an interesting discussion over the provision of technical standards see W.S. Peirce, "Innovation and Diffusion in a Single Europe: Institutional Structures and Industrial Prospects for the European Communities" in N. Nakicenovic and A. Grubler (eds.), *Diffusion of Technologies and Social Behavior* (Berlin: Springer-Verlag, 1991) pp. 37-51.

Section 1: Laws Which Directly Involve The Government

As discussed in Chapter 1, governments alter production, distribution and wealth creation decisions in various ways. A government action may or may not add to efficiency. The issue to be determined is which actions can and do lead to efficiency. A list of potentially efficient government actions and expenditures was set out in Chapter 1. This listing, however, was only the beginning of the analysis of what constitutes efficient law and efficient law making.

Besides providing services (including justice, defence, policing, health care and education), building infrastructure and redistributing income, governments supply two categories of law. While there is some overlap between the two categories of law, one can talk in terms of (1) laws which involve government actions and (2) laws which apply to firms, groups and individuals. As mentioned above, the first two sections of this chapter define these two categories of law. The third section asks how to determine when law is efficient.

Governments influence economic decisions in many ways. The most common way is through law making (taxation being an important subset of law making) and law enforcement. Law making is a broad category. It covers property rights (which often contain a tax element), and government regulation and legislation. Most of the power of government consists of four specific powers which will be addressed separately: the limits of power granted to the government by the constitution, the power to regulate, the power to tax and the power to both create and enforce property rights.

Virtually all government actions (or inactions) can and do effect economic behaviour. If economic behaviour has been altered, we should be able to determine, at least in a theoretical manner, whether economic behaviour has led to improved or diminished efficiency. As this is too difficult (and also too costly) to do at the time when each individual economic decision is made, it is useful to look at the institutional framework of government and the various laws and regulations which are enacted and enforced to determine whether efficiency has been enhanced or diminished. This will require a theoretical model of efficient government action. The government can use its powers to make and administer laws to change market behaviour. An efficient use of these powers must provide laws which regulate, tax, and enforce property rights in ways which will tend to maximize national satisfaction at the lowest cost.

The primary reason for all of the laws which involve the government is to define what role government shall take in the economy. Once the role of the government is established, other laws are needed to enforce government actions and decrees. Tax laws are necessary for governments both to regulate economic behaviour and to raise money for the government to operate (but primarily to raise revenue). Governmental law-making and regulatory power are subject to the constraints set out by the constitution.

1. The Constitution

H.C. Black defines a constitution as: "The organic and fundamental law of a nation or state, which may be written or unwritten, establishing the character and conception of its government, laying the basic principles to which its internal life is to be conformed, organizing the government, and regulating, distributing, and limiting the functions of its various departments, and prescribing the extent and manner of the exercise of its sovereign powers."⁷⁷ Because of its breadth and overriding importance, a discussion over how governments operate and influence economic decisions must begin with the national constitution.

The constitution lays out how the government can involve itself in the life of its citizens and other governmental entities (for example, agencies, other branches of government, states, provinces or municipalities). The constitution should, at least implicitly, lay out a nation's most elementary set of beliefs. It does this by being the institutional framework which defines the relationship between the government and the governed. A state's constitution (actual or de facto) defines the limits of the state's powers. In setting the limits of government power, it delineates the discretion which is given to the government to control the activities of its citizens. While many

⁷⁷ H.C. Black, *Black's Law Dictionary*, Fifth Edition, (St. Paul: West Publishing, 1979) at 282.

of the limits contained in a constitution apply to personal privacy, freedom and liberty, constitutions also have to contain provisions which set out the limit to which governments may interfere with private property. Private property is protected by constitutions which set limits to a government's power to nationalize industries and confiscate personal and real property, to tax and to regulate. A constitution also sets up a dispute resolution mechanism. The dispute resolution mechanism sets out how intergovernmental disputes are adjudicated and how an individual citizen can get redress in disputes which involve either the government or other parties.

The constitution is the broadest instrument for regulating how the government influences economic behaviour because it sets out the limits of the powers of the state. Any action breaching these limits is, by definition, unconstitutional. An economic analysis of the constitution can thus be used to demonstrate whether one type of constitution may be more efficient than another. It is also a natural starting point in determining what kinds of domestic laws will be efficient. The measurement of the value of post-constitutional and pre-constitutional decisions will be the focus of Section III of this chapter.

2. State Regulatory Power

At the outset, one would expect economic actors to adjust their behaviour according to the state's ability to interfere with individual activities. In considering the limits of the state's power one should consider not only the powers which the state has exercised in the past, but also powers which the state potentially possesses but has not yet chosen to exercise.

The most important actual and latent state power is the right to regulate (a regulation is considered a type of law for the purposes of this discussion). Governments make regulations which alter how scarce resources (including a clean environment) are allocated or how they may be used. This is often done at the request of an industry.⁷⁸ As discussed in Chapter 1, the decisions taken can radically affect prices and markets which leads to changes in investment, consumption and distribution patterns. Regulation can be used to alter property rights, such as regulations which either create or destroy state or private monopolies,⁷⁹ or grant or deny the right to pollute. Types of laws which fall under this category include: monopoly law, administrative law, environmental law, and health and safety law.⁸⁰

⁷⁸ See e.g. G.J. Stigler, "A Theory of Regulation", 2 *Bell Journal of Economics and Management Science* 3-21 (1971).

⁷⁹ In "The Welfare Cost of Tariffs, Monopolies and Theft", 5 *Western Economic Journal* 224-32 (1967) Gordon Tullock points out that monopolies rarely arise spontaneously. They have to be first created and second defended against competitive pressures that attempt to break them. Both efforts involve the use of scarce resources.

⁸⁰ C.R. Sunstein in "Paradoxes of the Regulatory State", 57 *University of Chicago Law Review* 407-441 (1990) points out that regulation has to be carefully drafted. He asserts that one of the paradoxes of the regulatory state is that some strategies intended to achieve certain ends have precisely the opposite effect to the one intended. Another paradox is that sometimes, when the effects of regulation will be known, the public argument made promoting the regulation will be opposite of the intended effect, since these arguments are the only winning ones. He gives various examples of regulatory paradoxes: (1) aggressive statutory controls frequently produce too little regulation of the private market; (2) stringent regulation of new risks can increase aggregate risk levels; (3) some federal environmental law that requires the best available technology has the effect of retarding technological development; (4) redistributive regulation harms those at the bottom of the socioeconomic ladder; (5) disclosure requirements may make people less informed; (6) independent agencies are not independent; and (7) restrictions on the availability of abortion, defended as a means of protecting human life, have resulted in the deaths of many women.

3. Tax Laws

Tax laws are used to raise revenue. Taxes are generally directly tied to property rights.⁸¹ Most types of taxes are imposed on the basis of income, property, wealth, possessions or usage. They also can radically change investment, consumption and distribution patterns since they impose costs on economic actors. The changes may be either intentional or unintentional, from the government's point of view. As indicated in Chapter 1, taxes are sometimes seen as an alternative to certain types of regulations. Even though the primary purpose of taxation may be to raise revenue, the following types of taxes are sometimes seen as ways to promote changes in personal or firm behaviour: driving fines, petroleum taxes, alcohol taxes, tobacco taxes, environmental taxes and tax incentives.

4. Property Rights

The final category of legal power which involves the government is somewhat different in purpose and scope. While the issue of property rights may well involve a dispute with the government, this is not the general case.

The manner in which resources are used depends on the property rights which are attached to them. Property rights refers to the bundle of entitlements defining the owner's rights, privileges and limitations for the use of property.⁸² Some forms of property rights can be traded or donated, others are available strictly to their current holders, still others go with the title or the position which one holds. Many constitutions contain provisions over property rights and may set out the degree of control that the state has over them.⁸³ The degree to which property rights are enjoyed and are tradable will also influence investment, consumption and distribution patterns.⁸⁴

In order to have value, property rights must be enforceable. While property rights can be granted through law, practice, custom, regulation or court decisions, ultimately it is the government which is almost always responsible for their enforcement. The government's involvement with property rights is often conditional. It enters the dispute upon being asked to adjudicate disputes or to sanction alternative dispute resolution procedures. Government protection of property rights come from policing and the administration of justice. The categories of law which are peculiar to the administration of justice are procedural law, administrative law and evidence law.

The policing element is interesting, as the state plays at least three different, but separate roles. First, if property is stolen, one generally goes to the police to find the criminal and to retrieve the stolen property. Second, theft is considered to be an offence against the state, not against the person from whom the property was stolen. The state prosecutor or magistrate then takes over and presents the case to a state appointed and paid judge or magistrate. Third, if the criminal is found guilty, the state is now responsible for the criminal's incarceration, parole conditions and administration and rehabilitation. This entire process is done both to punish the guilty and to create a deterrent against future theft.

⁸¹ A poll tax which is collected regardless of income, property, wealth, possessions, rights, usage, profession, licence or where one lives would be a notable exception.

⁸² A property right can be defined as the enforceable privilege to own, use, exploit or enjoy a specific item of property or any aspect of the property whether it be real property or personal property, tangible or intangible, or transferable or non-transferable. This right by its very nature has a value which others (including the owner of the property right) may or may not benefit from or even prize.

⁸³ See T. Anderson and P.J. Hill, "Constitutional Constraints, Entrepreneurship, and the Evolution of Property Rights", in J.D. Gwartney and R.E. Wagner (eds.), Public Choice and Constitutional Economics (Greenwich, Conn.: JAI Press, 1988) pp. 207-28.

⁸⁴ For a further discussion of property rights and property rights enforcement see Chapter 1, Section III.

In addition to the criminal administration of justice, there is also a civil justice system. The civil court system is almost entirely devoted to the definition and enforcement of property rights.⁸⁵ In this process the state only provides the judicial bureaucracy.⁸⁶ The services of the court are generally provided free or at a nominal charge to the litigants. The state treasury absorbs most of the costs of the civil court system. What benefits does the state get out of providing below cost civil adjudication?

While the state is not a participant in most civil actions, it does have an important stake in the system. How property rights are enforced will directly affect the size of the tax base. If property rights are enforceable and certain, more trade will occur.⁸⁷ Increased trade means increased economic activity. Since virtually all taxes are directly tied to economic activity, the enforcement of property rights affects the size of the tax base.

Section 2: Laws Which Directly Apply To The Citizenry: Background Law

The purpose of this section is to discuss the type of laws which form the basis of civil administration. This type of law will be called "background law." It is important to realize that all background law is based on regulating various forms of property rights and that the government has an important stake in the creation and enforcement of property rights. As Jürgen Backhaus puts it, the government has an interest in background law because it "broadens the tax base and increases its fertility by expanding the production possibility frontier of the economy."⁸⁸

1. Definition

Background laws are the laws which work in the background of contractual relations. Chapter 1, in trying to express the relationship between laws and markets, outlined the ways in which labour laws and real estate laws could affect markets. The purpose of this was to illustrate that differences in background laws will create different markets. To the extent that these background laws regulate the markets in ways which maximize satisfaction they are efficient. They may be doubly efficient since in addition to regulating an efficient outcome, they save on transaction costs. Certain terms regarding contractual relations between certain parties do not have to be negotiated: they are already included in the background law and the time needed to negotiate these issues is saved.

Background law comes in the form of codes and regulations in pure civil law countries; in common law countries it derives from judge-made law, statutes, codes and regulations.⁸⁹ Background law includes: criminal law (to

⁸⁵ Slander and libel actions may be considered an exception. Slander and libel actions, however, involve the value of one's "good name." A "good name" is a scarce resource, personal in nature, and has some value. While it cannot usually be traded, it could still be thought of as a property right.

⁸⁶ Violations of court orders are considered to be criminal offenses.

⁸⁷ E.C. and L.F. Banfield describe the extreme example of an Italian village where trust was absent and property rights were enforced by might. As a result trade declined, and in time almost ceased. The village remained very poor while the rest of the country became much richer. Moral Basis of a Backwards Society (New York: The Free Press, 1958).

⁸⁸ J. Backhaus, "Efficient Statute Law" in M. Faure and R. van den Bergh (eds.), Essays in Law and Economics: Corporations, Accident Prevention and Compensation for Losses, (Antwerp, Apeldorn: Maklu, 1989) pp. 23-32 at 29.

⁸⁹ There has been a spirited debate in the literature over the issue of whether common law or civil law produces better background law. For an overview of this debate see Backhaus, *Ibid.* In our theoretical discussion, the source of the law is unimportant since one can certainly point out examples of both common law and statute law which tend to increase efficiency.

a certain extent), contract law, finance law, bankruptcy law, labour law, landlord-tenant law, agency law, debtor-creditor law, domestic relation law, insurance law, partnership law, real and personal property law, commercial law, tort law, wills and trust law and company law.

2. Standard Form Contracts

In discussing efficient background law it is useful to begin with a discussion of standard form contracts. Standard form contracts have received a great deal of negative attention but can greatly add to efficient outcomes.⁹⁰ They may be more prevalent than many people realize. "Standard form contracts probably account for more than ninety-five percent of all contracts now made. Most persons have difficulty remembering the last time they contracted other than by standard form; except for casual oral arrangements, they probably never have. But if they are active, they contract by standard form several times a day. Parking lot and theatre tickets, package receipts, department store charge slips, and gas station credit card purchase slips are all standard form contracts."⁹¹

Unlike the standard form contract individuals have to accept the operating parameters set by background laws. While one may choose to park his car elsewhere, he can never avoid death, and it is difficult to avoid owning or renting property, paying taxes, or working.

Standard form contracts are useful because they make the cost of negotiating very low. If each party had to negotiate all the conditions and the warranties of a contract individually, it would be impossible to issue credit cards, it would be impossible to receive packages and it would be difficult to leave clothes at the laundry. The negative side is that it is difficult not to accept the conditions pre-written on the form. Standard form contracts are not always enforced by courts. Courts may object to standard form contracts if their terms contradict background law (i.e. the uniform commercial code) or public policy. Additionally, the terms of the contract may not always be terms which would be accepted if the parties had equal negotiating power or access to similar relevant information. If the terms are onerous the courts have often failed to recognize them.

3. Relation to Background Laws

Background laws work in a similar manner. Like standard form contracts, they preset the conditions under which transactions are made. In standard form contracts, one party, usually the merchant, provides the terms of the contract on a monopoly basis. Although the merchant is a monopoly provider of the terms of the contract, the customer is free to search out stores who offer less onerous conditions.

If the terms are one-sided, they cannot be efficient, even if they are not enforced. They may well save on transaction costs, but the outcome will almost certainly be viewed as being inequitable. Background laws, too, can be equitable or inequitable. If they are to be considered efficient they must both be equitable and lower transaction costs.

4. Transaction Costs

Transaction costs occur in market exchanges. They are a cost of doing business. They include the time and costs which are necessary to do research; search for parties to exchange with; to reach agreements, and to monitor the performance of the contract. There are transaction costs not only when buying goods, but also when consuming

⁹⁰ M.J. Trebilcock and D.N. Dewees, "Judicial Control of Standard Form Contracts" in P. Burrows and C.G. Veljanovski, The Economic Approach to Law (London: Butterworths, 1981).

⁹¹ W.D. Slawson, "Standard Form Contracts and Democratic Control of Lawmaking Power", 84 Harvard Law Review 529-566 (1975).

services or hiring employees or agents.⁹² How technology has effected these transaction costs and the significance of these cost changes will be extensively explored in Chapter 5.

5. Importance of Background Laws

Background law is important because it sets parameters for individual behaviour. Background law is important for the same reason constitutions are important: they provide the limits of permissible actions.⁹³ They often also set out guidelines or contain provisions for dispute resolution.

Background law is virtually indispensable for most types of commercial transactions. Background law sets out the rules and the parameters under which commercial transactions may take place. In Chapter 1, market enforcement conditions for loan sharking and for personal betting were set out. These, while demonstrating that transactions can occur without background law, are exceptions. The purpose of these examples was to show that various types of coercion can efficiently enforce the performance of private contracts. It is unlikely that an acceptable modern international trading system could be built on this basis.⁹⁴ It is even more unlikely that a firm could operate efficiently if all its work and all relationships were based on coercion.

6. How Background Law Works: Contracts Within Firms

Contracts are transactions in which parties exchange promises of value, for their mutual benefit. Since there seems to be some confusion⁹⁵ over the types of contracts which exist in a firm, each group of stakeholders (the creditors, shareholders, managers, and employees) will be discussed in turn.

But first it will be useful to discuss why firms develop. In "The Nature of the Firm," Ronald Coase argued that firms exist to reduce transaction costs. Since gathering information, contracting and monitoring can be expensive, a firm may be able to achieve economies of scale in these areas. To the extent that firms are able to do this at lower cost than individuals, they will be efficient and cost effective. In the firm, the time-consuming bargaining process can be minimized through the development of hierarchical structures, skill specialization and by issuing orders to the economic actors through a series of general commands. The commands through the hierarchical structure reduce transaction costs.⁹⁶

⁹² For an excellent discourse on transactions costs and their effect on contractual relationships see O.E. Williamson, Economic Organization (Brighton: Wheatsheaf Books, 1986) at 101-130 and 174-191.

⁹³ The concept of minimally acceptable standards also applies to constitutional law - many constitutions have human rights clauses (including *habeas corpus*), limitations on state-of-emergency powers, etc. which set minimum standards for government behaviour and for its agents (the police, judges and other government officials).

⁹⁴ International drug smuggling is a notable exception. In footnote 15, I provided an example of the Italian village where a lack of trust and consistent legal enforcement caused trade to virtually cease over time. This illustrates that while it is possible for criminals to provide efficient enforcement for certain limited activities, a comprehensive trading system can probably not be built on such a basis.

⁹⁵ See A. Shleifer and L.H. Summers, "Breach of Trust in Hostile Takeovers", in A. Auerbach (ed.), Corporate Takeovers: Causes and Consequences, (Chicago and London: Chicago University Press, 1988) pp. 33-56; S. Rosen, "Implicit Contracts: A Survey", 23 Journal of Economic Literature 1144-1175 (1985); W.A. Law, "A Corporation is More than Stock", 64 Harvard Business Review 80-83 (May-June, 1986); and "Economic Focus: Do Poison Pills Make You Strong?" The Economist (June 29, 1991) p. 63. In a private correspondence, I learned that "Economic Focus" was written by Matthew Bishop, an economics correspondent.

⁹⁶ R.H. Coase, "The Nature of the Firm," 4 Economica 386 (1937) in R.H. Coase, The Firm, the Market and the Law (Chicago and London: University of Chicago Press, 1988).

The firm is based on a series of voluntary contracts between the firm itself and various interested parties.⁹⁷ Some of these contracts are explicit and some are implicit. Not all contracts are explicit because the future is uncertain, and the cost of negotiating and developing explicit contracts for each and every contingency would be excessive.⁹⁸ Some matters which are left implicit are explicitly covered by background law. The areas of background law which cover contracts between the firm itself and various interested parties include: labour law, contract law, landlord-tenant law, agency law, debtor-creditor law, insurance law, property law, company law, finance law and bankruptcy law.

Background law in the firm works in two ways. The first is that it sets minimally acceptable standards. Second, it fills in at least some of the gaps in the contract.

As an example, let us consider bankruptcy law to demonstrate how background law may fill in gaps and create minimal standards. A firm is engaged in the provision of services. It rents a building and leases the office equipment (furniture and computers). There is a contract between the firm and a bank which states that in the event of bankruptcy, the bank has an absolute first claim to the proceeds of the liquidation. The employee's labour contracts do not discuss the possibility of bankruptcy. The cash flow of the firm becomes negative and it files for bankruptcy on the 27th of the month. Workers are paid at the end of the month. The assets of the firm are not sufficient to fully cover either the voluntary creditor (the bank) or the involuntary creditors (the workers). The issue is which creditors have a priority claim to the remaining funds held by the firm: the bank or the former employees?

Under ordinary contract law, the express terms of the contract would prevail. Since the bank had a contractual priority to the proceeds of the liquidation, they would get the funds. This is not the outcome in at least some countries. In at least some countries, the workers would get the money. The bankruptcy laws accomplish two things. First they fill in the terms of the employment contract by giving workers a preferential claim to the remaining money. Second, the bankruptcy laws set out minimum standards of public acceptability which may well lay down that involuntary creditors (in this case the workers) have a priority over voluntary ones (like the bank), even if the contract states otherwise.⁹⁹ One should note that, as a matter of public policy in at least some countries, an express provision in the employment contract which stated that in the event of bankruptcy, workers are to be considered unsecured creditors (with a claim junior to the secured senior creditors) would not be enforced. The bankruptcy code standard that workers are entitled to a position senior to banks for previously earned income would still apply.

Other types of background laws work in similar fashions.

7. The Parties Involved in Contracts Within Firms

In the words of Jensen and Meckling: "Contractual relations are the essence of the firm, not only with the employees but with suppliers, customers, creditors, etc. ...The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships..."¹⁰⁰ Since contractual relations are at the core of the analysis, it is useful to see what types of contracts exist between the firm and interested parties. In relation to these contracts, the areas of applicable background law which protect the contracting parties will be pointed out.

⁹⁷ B.D. Baysinger and H.N. Butler, "The Role of Corporate Law in the Theory of the Firm", 28 Journal of Law and Economics 179-191 (1985) at 179.

⁹⁸ S.J. Grossman and O.D. Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration", 94 Journal of Political Economy 691-719 (1986).

⁹⁹ R.A. Posner, Economic Analysis of Law, Third Edition, (Boston and Toronto: Little, Brown and Company, 1986) p. 372.

¹⁰⁰ M.C. Jensen and W.H. Meckling, "Theory of the Firm: Management Behavior, Agency Cost and Ownership Structure", 3 Journal of Financial Economics 305-360 (1976) at 310-11.

a. Stakeholders

Stakeholders (creditors, customers, suppliers, employees, managers and shareholders) other than shareholders want a relatively risk-free fixed return, agreed to in advance. Shareholders with limited liability take the residual risk in return for the residual gains. The amount of risk which each of the parties takes is itself a legal matter, which derives from debtor-creditor law, the bankruptcy code and the explicit contract itself.

b. Creditors and Suppliers

Since shareholders have obtained limited liability status for the firm through incorporation (for which company law provides the background law), few suppliers and other creditors supply goods, financing or services on the basis of trust alone if they can help it.¹⁰¹ Most creditors try to get some kind of security before extending credit. Security can come in the form of a lien, a letter of credit, a retainer, a prepayment or another type of secured interest. Those that do not obtain a secured interest extend credit knowing that their final hope of getting paid is in the bankruptcy court. Unsecured creditors rarely get paid in full when bankruptcy occurs. For this reason, if a company is seen or even rumoured to be in trouble, creditors demand greater assurance of being paid. Creditors who extend credit without security should receive some form of risk premium in the form of higher prices or fees. The amount of the risk premium should negatively correspond with the chance of being paid. This may help explain why creditors in different countries pay different real interest rates.¹⁰²

Since bankruptcy laws differ from country to country, credit is extended on different terms in different places. For example, America's Chapter 11 bankruptcy protection gives better protection to those creditors who extend credit after Chapter 11 is declared than to previous unsecured creditors. This gives creditors an incentive to provide additional credit for firms which are reorganizing. The rationale behind this policy is that continued trading coupled with a subsequent reorganization may be in the overall best interest of the creditors whose claim was established before bankruptcy was filed.

c. Customers

Even in the simplest contract, customers are usually protected by background laws: tort law, environmental laws, health and safety regulations, regulations against false claims and advertising and the commercial code. All set up minimum standards. Tort law, environmental laws, and health and safety regulations help ensure that products are safe and that the processes under which they were manufactured were relatively environmentally friendly. The commercial code provides certain warranties for goods which are sold by firms, such as that goods are suited for the use for which they are intended. While certain warranties can be waived, most of these protections can be enforced despite the specific words of the contract. Customers who do not receive such comprehensive protection should pay less for the goods or services.

d. Shareholders

Shareholders have a package of rights. The most important of these rights (in most countries, under most circumstances) are the rights to receive dividends and the residual value of the company in the event of bankruptcy or liquidation; the right to transfer shares, through sale, gift or inheritance; and the right to vote at shareholders meetings. While shareholders do not have the right to hire or fire managers, they do have the right to vote for some, if not all, of the directors. They appoint managers by electing the directors who appoint the managers. Directors are elected according to the provisions contained in the statutes and by-laws of the company. Subject to the constraints of company law, these statutes and by-laws are a form of contract and shareholders may vote to change them.

¹⁰¹ Posner points out that the practical effect of limited liability shifts some of the risks of default from the shareholder to the creditor. *Supra* note 27 at 370.

¹⁰² For an excellent analysis of the real cost of borrowing money and how bankruptcy laws can influence costs see "International Finance: The Ebb Tide", *Economist Survey* (April 27, 1991).

e. Employees

Employees are hired on fixed terms. Labour law sets out minimum terms and conditions for employment contracts, such as the number of hours worked, paid holidays, sickness benefits, maternity leave and redundancy terms. Employees are generally given the right, under labour law, to organize and join unions and to bargain for wages and benefits collectively.

d. Managers and Directors

Managers and directors are hired by the firm to run the company in the best interest of the shareholders (in some countries the stakeholders). The conditions and terms of employment of managers and directors are also covered by labour law. Managers and directors generally act as agents of the firm. As agents of the firm, they hold the position of fiduciary. As fiduciaries, they owe loyalty to the firm itself, even if this at times means falling on their own swords; the problems begin when they do not act in this fashion.¹⁰³ In return for their faithfulness, managers and directors generally get a fixed term contract whose terms may entitle them to a share of the profits or revenues.

8. Hostile Takeovers: Are Poison Pills Healthy?

The notion of background law is important since background law protects all the interested parties of a firm. There is one argument which is particularly perplexing. Andrei Shleifer and Lawrence Summers advocate that under the threat of a hostile takeover, extending the contract terms of employees and using "poison pills"¹⁰⁴ may be good for the firm and society.¹⁰⁵ They argue that explicit contract terms, negotiated in good faith, providing terms which are mutually beneficial should be unilaterally extended in some cases. Although a discussion of poison pills may seem out of place here, a critique of their argument shows how efficient background laws should operate and how the minimum standards provided by background laws should not, as a general rule, be used to supersede explicit contract terms.

a. Short-Term Detriment = Long-Term Benefit

A unilateral addition to the terms of an employment contract, granted by managers who face losing their jobs, in order to thwart a hostile takeover is, with certain limited exceptions, to the detriment of the shareholders. In arguing that this may be beneficial, Shleifer and Summers assume that those attempting to make hostile takeovers do not know how to act in their own and the other shareholders' best interest. Shleifer and Summers' also assert that post-takeover cost-cutting may lead to an anti-egalitarian redistribution from workers to shareholders. To Shleifer and Summers this redistribution comes in at least some cases in the form of higher share prices to

¹⁰³ The need for managers and directors to work as fiduciaries is a relatively recent phenomenon. It derives from the separation of ownership and control in the modern publicly held corporation. Freeing the management from the effective day-to-day control of the owners (the shareholders), may free them to pursue their own ends and objectives. Shareholders needed the legal device of the "fiduciary." Being a fiduciary means that the managers, directors and controlling shareholders must put the interests of the firm above their personal ambitions. The duties of a fiduciary therefore are a duty of care and a duty of loyalty. Enforcement of fiduciary responsibilities comes from a "derivative suit" brought by one or more shareholders on behalf of the firm. A.A. Berle and G.C. Means, The Modern Corporation and Private Property (1932), Revised edition (Buffalo: William Hein 1982). In 1932, in response to Berle, W.S. Dodd asked: "For Whom Are Corporate Managers Trustees?" 45 Harvard Law Review 1145-1162 (1932). See also Posner, *Supra* note 27 at 389-90.

¹⁰⁴ Poison pills are a weapon to help fight hostile takeover bids. Their purpose is to make hostile takeovers more expensive, thus more difficult to swallow.

¹⁰⁵ *Supra* note 23.

shareholders at the expense of employees and "shut down factories that dominate the economies of several small towns. As a consequence numerous local stores, restaurants, and bars go bankrupt."¹⁰⁶

What Shleifer and Summers do not seem to realize is that the cutbacks which caused so much hardship were probably long overdue. If the cuts are not made the entire company will probably eventually go bankrupt. This will make all of the company's employees redundant. The critical issue is not whether the former employees and small towns will be hurt by the actions, the issue is when, who and how many will be affected. If it takes cutting off a leg to save the body, this may be better for society than letting the body die.

In the long-run, in a competitive market, firms cannot be over-staffed or pay employees more than their marginal value. Relatively inefficient firms in competitive markets eventually go out of business.¹⁰⁷ Moreover shareholders are entitled to profits. Without profits no one will invest in shares. It makes little sense for a shareholder to bear most of the residual risks and receive little or none of the residual gains in return. If shareholders are required to retain their investment in firms which are uncompetitive, eventually more than the few towns and employees which Shleifer and Summers mention will be affected by the cost-cutting. Investment will flow to places which are more hospitable. This capital flight and the competitive environment for investment capital will be the focus of the second part of this book. But if laws are passed which make it difficult for shareholders to retain the residual value of their investment, first all of the stakeholders and ultimately the communities where the firms operate will be adversely affected. If the hostile takeover is allowed to succeed, the resulting body may have to limp or hobble for a while, but at least the body will have a chance to recover.

b. Terms of Explicit Contracts

Employees are free to contract for as long an employment term as they desire. Regardless of the length of the contract, all employees take the risk that they will not be retained at the end of the contract period. If they elect to contract for shorter periods, one would expect that they take on some additional risk. Workers are however entitled to contract for longer periods of time. This means that the employees (or managers) take less risk. One would expect that those who take less risk would also receive less rewards, in the form of lower pay or benefits. The level of redundancy pay which an employee will receive is a matter which is initially covered by local labour law, but may be augmented by the terms of the contract.

The action advocated by Shleifer and Summers to unilaterally increase employment terms is not bargained for. Workers receive all of the benefits and bear none of the costs. If the extension of contractual terms was bargained for, one would have expected the employees to take lower pay in return. Once one can get over the genuine grief which compassionate people feel for those losing their job due to little fault of their own, it is untenable how Shleifer and Summers can make an economic argument that actions which one group receives all of the direct and indirect benefits of contractual relations and bears none of the risk or the cost can be considered beneficial to the firm or society. The activities of Robin Hood (stealing from the rich and giving to the poor) create applause in the short term; but it eventually creates a strong disincentive to stay and create wealth in Sherwood Forest.

c. Who Determines the Value of Trust?

What those contemplating hostile takeovers are saying is that they know better than the managers (or the market) what value is contained in the firm. One of the major sources of value is locked up in the existing contracts and the trust developed between the firm and its customers, suppliers, managers and employees. Those contemplating hostile takeovers know full well that if they gain control over the firm, they cannot abrogate the terms contained in the existing contracts between the firm and its stakeholders; if they could, then those who are against hostile takeovers would have a point. But a contract between the firm and another party survives after new owners and managers take over.

¹⁰⁶ Ibid. at 35.

¹⁰⁷ For a slightly different perspective on the likelihood of bankruptcy for inefficient firms see R. Nelson and S. Winter, An Evolutionary Theory of Economic Change (Cambridge: Belknap Press, 1982).

As Shleifer and Summers point out, destroying this trust (which they say is part of the implicit contracts) may also have negative ramifications. Rational owners will certainly not do this. The new owners will make the determination of the value of trust *ex post*. Shleifer and Summers seem to want non-owners to determine the value of trust *ex ante*. It is reasonable to assume that those contemplating a hostile takeover have reasonable grounds to pay shareholders more than the current market value for their shares.¹⁰⁸ It is not reasonable to assume that rational investors would do anything to jeopardize relationships between themselves and valued customers, suppliers, managers or workers. If they did, the firm would not be as valuable to them.¹⁰⁹ Changing the contractual provisions between the firm and the stakeholders, without getting something of at least equal value in return, smacks of mismanagement and might be considered a breach of fiduciary responsibility.

d. Renegotiated Contracts

This is not to say that additional security and trust should be offered by the new owners of the firm. It may be mutually beneficial for the new owners and the stakeholders to renegotiate a contract for the benefit of both parties in the light of the change in circumstances. A renegotiation of explicit contracts may rebuild the valuable trust which Shleifer and Summers indicate may be lost when a takeover takes place. Managers who may lose their job if the hostile takeover is successful, however, have no right to unilaterally give away valuable rights which belong to the shareholders, especially when the primary beneficiary of this action is the managers themselves, not the present or future shareholders.

There is a fundamental flaw in the theory of implicit contracts. The theory is that certain terms which were not discussed in a contract should be recognized by courts. If this theory is brought into practice, different courts, without the benefit of background law or explicit contract terms, will almost necessarily read the terms and the facts differently. This means that there is more risk in signing explicit contracts (at least on one side). One can surmise that higher risks will mean that fewer otherwise beneficial transactions will ensue.

The alternative is for courts to rely on the explicit contract terms and the provisions of background law for guidance. This approach will take the role of guessing what the intentions of the parties were or might have been away from judges; at the same time the parties are protected by the minimum safeguards set out by background law. This will create some certainty amongst the contracting parties as to what their rights and obligations will be in the event that some incident which is not covered by an explicit contract term transpires. If the background law does not prove to be sufficient, then the parties are free to explicitly contract for higher protections. If reasonable background laws are in place, an express recognition of implicit contract terms will be inefficient law.

¹⁰⁸ B. Holmstrom, "Comment" in A. Auerbach (ed.), Corporate Takeovers: Causes and Consequences (Chicago and London: Chicago University Press, 1988) pp. 56-61.

¹⁰⁹ The point of who should value trust can also be illustrated by a non-hostile takeover. In December, 1990 Nationale Nederlanden, the largest Dutch insurance company, merged with NMB Postbank Groep NV, the third largest Dutch bank (which was formed by a 1989 merger between the Postbank, which was exclusively a retail bank, and Nederlandsche Middenstand Bank, a commercial bank). After the merger was announced, the insurance industry and insurance brokers decried that the newly merged firm would work outside the established insurance network and that this action would lower their profitability. They then threatened not to sell Nationale Nederlanden products through their network, as they regarded the merger as a breach of their implicit contract with the firm. This was an attempt to scuttle the then proposed merger. One would expect that potential loss of Nationale-Nederlanden's distribution system would have an adverse effect on the share prices of one or both of the merging firms. Overall, private and institutional investors thought otherwise; the share price of the two companies outperformed the market by an average of about 14 per cent. One of the reasons for the merger was to use outlets of NMB Postbank as a distribution network. R. Cremers and A. Tourani Rad, Een Empirisch Onderzoek Naar de Gevolgen van Fusie Tussen Nationale Nederlanden en NMB-Postbank Groep, Research Memorandum RM 91-015, University of Limburg (1991). The Dutch insurance brokers ended their boycott nine months later. "For the Record", International Herald Tribune (September 2, 1991) p. 11.

However, if Shleifer and Summers and others advocating the implicit theory of contracts¹¹⁰ want to argue that one or more national labour laws are inefficient, in that it does not maximize societal satisfaction, this is an entirely different issue. On this issue they may be correct - this is and should be seen as a political, not a legal, determination. But their claim, that a breach of trust has occurred when all of a contract's terms have been lived up to, shows both a complete misunderstanding of both contract law and what is in the best interests of the firm. The place to go in the advent of insufficient protections is not the courts, but the legislature. Should the legislature pass or amend background laws, the changes in the legal atmosphere will be initially and continuously transparent to all potential contracting parties (or at least their lawyers); ad hoc court decisions will not provide either transparency, clarity or consistency - all elements of efficient law. This transparency and clarity will allow parties to know the rules of the game and to play the game accordingly.

9. The Goal of Background Law

The concept of background law should now be clearer. Background laws should be seen as types of default mechanisms. If they are commonly agreed upon and are in fact efficient (see chapter I) and have not been formed in order to promote the interests and rights of certain groups at the cost of others, these laws can lead to high levels of savings since they will necessarily lower transaction costs. Using this as a theoretical basis, the aim of efficient background law should be both to minimize the costs of making pre-contractual decisions and to maximize the value of post-contractual decisions. This calls for some measurement. Section III will discuss how these measurements should be made.

Section 3: How To Measure Whether Law Is Efficient

Chapter I outlined the types of government actions which would be efficient. The objective of efficient background law is to minimize the social costs of an activity. This is a two-step process. Guido Calabresi's analysis of accident law can be used as a model. "The principal function of accident law is to reduce the sum of the cost of the accidents and the cost of avoiding accidents."¹¹¹ This section adopts this framework for determining how to measure efficient background law. Efficient background law will lower risk and uncertainty and minimize the costs of doing business.

1. Lowering Risk and Uncertainty: Constitutions

While, as Hayek suggests, the consideration of general constitutional rules cannot be undertaken with particular cases in mind,¹¹² constitutional rules can help enhance decision making. At this point the term "constitution" should be redefined. Previously, a constitution was shorthand for a national constitution. At this point, an alternative (first) definition is taken from the American College Dictionary. Under this definition a "constitution" is the way in which anything is formed, composed or made-up.¹¹³ Chapter I set out how laws and markets interact: markets are constituted on a set of legal norms. In this section, the term constitution, except where a national constitution is indicated, will refer to the set of legal norms which operate to create a functional market. For example a set of company laws provides the framework constituting a working market. For example, Hans

¹¹⁰ For an overview of those advocating recognizing implicit contracts see Rosen, *supra* note 23.

¹¹¹ G. Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* (New Haven: Yale University Press, 1970) at 42.

¹¹² F.A. Hayek, *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960), p. 210.

¹¹³ *The American College Dictionary*, C.L. Barnhart (ed.), (New York, Random House, 1966).

Tietmeyer, Vice-President of the Bundesbank, calls the Bundesbank Charter "one of the most successful and best monetary constitutions in the world."¹¹⁴

a. Buchanan and Tullock

In The Calculus of Consent, Buchanan and Tullock set out what the "ideal organization" of a national constitution should accomplish. While not prescribing any particular constitution, they implicitly use an efficiency analysis to assess what type of constitution should be adopted. They assert that constitutions should be designed to maximize the value of post-constitutional decisions. Buchanan and Tullock asserted that the role of the constitution is to set up a system of constraints which should act to limit the ability of individuals and coalitions to impose internal costs on others.¹¹⁵

This analysis is helpful, but it only takes us part way in describing what an efficient constitution should do. Tullock and Buchanan, as suggested by their own and their followers' writings, are very concerned with private groups and other individuals hijacking the offices and law making and law enforcement powers of government officials. They suggest that the use of public offices for private gains ("rent-seeking") is inefficient. It is only natural that their concern centres on creating safeguards against this process. To nip this type of action ("rent-seeking") in the bud, the constitution, a document which sets the limits of government powers, seems to be the most elementary starting point. As described above, the national constitution should inherently lay out the most elementary beliefs of a nation. Tullock and Buchanan's assertion, that the role of the constitution is to set up a system of constraints which should act to limit the ability of individuals and coalitions to impose internal costs on others, while it does give one specific good which a constitution should provide,¹¹⁶ does not give any clues on how to maximize the value of post-constitutional decisions or to limit the cost of maximizing the outcome.¹¹⁷

However, by not describing what maximal post-constitutional decisions should look like, one can assume that Buchanan and Tullock are implicitly stating that each society places different values on post-constitutional decisions and that each country may have different internal costs. If this is true, one could conclude that there is no universally ideal constitution or organizational structure since an efficient constitution (one that maximizes the value of post-constitutional decisions) will take into account the internal cost and value differences. The different values which different countries place on post-constitutional decisions shall be one of the focuses of Chapter 4.

¹¹⁴ Quoted in D. Marsh, "Germany Gets the Monetary Jitters", Financial Times (August 6, 1991) p. 16. Tietmeyer is referring to the economic, not the legal constitution of the Bundesbank. The Bundesbank is chartered by the *Bundesbankgesetz* which is not governed by the German constitution. The charter can be amended by a simple majority of the lower house of parliament and provides the finance minister with ample room for intervention. Nevertheless, as this intervention is currently almost unthinkable, the economic constitution of the Bundesbank is strong.

¹¹⁵ J.M Buchanan and G. Tullock, The Calculus of Consent, (1962) Reprint (Ann Arbor: University of Michigan Press, 1983) at 289-91.

¹¹⁶ Buchanan makes this point elsewhere with Geoffrey Brennan in The Power to Tax: Analytical Foundations of a Fiscal Constitution (Cambridge: Cambridge University Press, 1980); and The Reason for Rules: Constitutional Political Economy (Cambridge: Cambridge University Press, 1985).

¹¹⁷ In The Calculus of Consent, Buchanan and Tullock lay out a generalized economic theory of constitutions. In Chapter 6, they state that different organizations impose different costs. They approach this from the viewpoint of individual choice among collective decision-making rules. In contrast, the present discussion is somewhat broader since its theory of constitutions constraints itself to a discussion of establishing institutions which maximize satisfaction at the lowest possible costs. Collective actions should be analyzed in terms of the analysis set out in Chapter 1. Ibid. at 63-84.

How then can the government promote efficiency? As with constitutions, government actions, laws and regulations should work ex ante to maximize both government and individual decisions ex post. This can be done through the provision of laws and regulations which minimize internal costs and maximize satisfaction. This involves two separate and inherently different processes which are important for reasons which may not be obvious: minimizing the cost of pre-constitutional decisions and maximizing the value of post-constitutional decisions. Toward these ends institutions can be set up which minimize the need for parties to have disputes regarding their relative legal positions. If persons know what their relative legal positions are they will be able to contract with one another with a more certain outcome, and to insure the outcome through third parties at a low cost.

b. Pre-Constitutional and Post-Constitutional Decisions

In The Calculus of Consent, Buchanan and Tullock do not discuss minimizing the costs of pre-constitutional decisions.¹¹⁸ While one could deduce that any value maximizing decision inherently involves cost minimization, the processes for analyzing each part of the process, in determining whether a law is efficient, are somewhat different.

An efficient constitution or legal structure must perform three operations as far as economic decisions are concerned. First, the constitution or legal structure must set up a framework for the decision process. The framework for the decision process works ex ante (before decisions are actually made). Second, the constitution or legal structure acts during the decision making process by helping shape supply and demand functions (both of which are a function of the framework). Third, the constitution of legal structure must act after the decision making process has been used. The third operation was partially described in Chapter 1 as the efficient enforcement of legal norms. These two operations work ex post (after a decision to enter the market was made).

i. Minimizing the Costs of Pre-Constitutional Decisions

Chapter 1 described what an efficient market would look like. An efficient market prices goods so that exchanges can be made which maximize satisfaction. Just as proper pricing is necessary in order to price goods and services at a level which maximize satisfaction, efficient legal norms and their enforcement will also include a pricing mechanism. The pricing mechanism of efficient laws will minimize internal costs to others. To achieve this, the laws should be clear and consistent.

Clarity, consistency and transparency are three elements which can minimize the cost of pre-constitutional decisions, but these conditions alone do not guarantee efficiency. Take for example, a well publicized, strictly enforced law which guaranteed death by firing squad for persons who resold tickets to a World Cup football final for more than the face value. Let us now assume that all 100 people who were caught violating this law were summarily executed. The law which was applied was unusually clear, consistent and transparent. This type of law probably added little to efficiency. One could argue that the 100 deaths occurred because the market was inefficient. Tickets were scarce because demand exceeded supply at the price for which the tickets were initially sold. The victims of this were acting as entrepreneurs who chose to accept at least two market risks. The first risk was that they would be able to sell the tickets for more than they paid for them. The second was that they would not be caught. Clarity and consistency alone did not lead to proper pricing either in terms of creating an efficient cost structure or minimizing internal costs.

¹¹⁸ They do, however discuss this matter separately elsewhere. Buchanan in The Limits of Liberty: Between Anarchy and Leviathan (Chicago: University of Chicago Press, 1975); and Tullock in Private Wants, Public Means: An Economic Analysis of the Desirable Scope of Government (New York: Basic Books, 1970).

ii. Maximizing the Value of Post-Constitutional Decisions

Buchanan and Tullock as well as Williamson¹¹⁹ argue that many constitutions and institutions should be designed to minimize the problems associated with opportunistic behaviour where contracts are implicit. Constitutions to be efficient over the long term must set up a system of constraints which should act to limit the ability of individuals and coalitions to impose internal costs on others.

This alone is also insufficient. Safeguards against opportunistic behaviour alone do not indicate that the structure agreed to was efficient in the first place. Even if the structure was indeed efficient in the first place, one should of course recognize that a delicate balance must be struck. If prohibitions against opportunistic behaviour are overly stringent the constitution may not have sufficient adaptability to cope in a rapidly changing world. If one is truly interested in maximizing the value of post-constitutional decisions, the framework must be efficient to begin with and be sufficiently flexible to take into account the volatility of both conditions and attitudes.

c. Williamson

Oliver Williamson argues that governance structures, including but not restricted to legal structures (which are types of constitutions), "need to be matched to transactions in a discriminating way if efficient and viable contractual relations are to occur."¹²⁰

Williamson also gives us a theoretical background indicating the conditions and the proper dimensions for efficient background law. He describes the critical dimensions for assigning some transactions to markets and others to internal organizations. The dimensions are:

- (1) the degree of uncertainty;
- (2) the frequency with which the transactions reoccur; and
- (3) the degree to which durable transaction-specific investments are required to realize least-cost supply.¹²¹

His analysis also tells us under which conditions contractual provisions should be assigned to background law rather than individually negotiated. This outline is also the basis upon which the final part of this section builds.

2. Minimizing the Cost of Doing Business: Transaction and Agency Costs

Once the structure is in place which will tend to maximize satisfaction, a focus can be placed on minimizing the cost of achieving this outcome. Under the Williamson scheme, it will be more efficient to provide background law when uncertainty is low (events are likely to happen), transactions occur frequently and if the agency cost of renegotiating each time is high.¹²² Under this set of circumstances the provision of a background law which provides certainty of outcome at low cost with a result which maximizes societal satisfaction will lead to lower transaction costs, lower risk, and greater certainty of outcome on a basis which is mutually desirable.

a. Coase

Ronald Coase, when discussing the market mechanism and the firm, might have used a similar explanation to analyze the notion of efficient background law. In "The Nature of the Firm," Coase stated that: "The cost of

¹¹⁹ O.E. Williamson, *The Institutions of American Capitalism* (New York: Basic Books 1985).

¹²⁰ O.E. Williamson, "Contract Analysis: The Transaction Cost Approach", in P. Burrows and C.G. Veljanovski (eds.), *The Economic Approach to Law* (London: Butterworths, 1981) p. 39.

¹²¹ O.E. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations", 22 *Journal of Law and Economics* 233-261 (1979).

¹²² Under background laws, the cost of negotiating is amortized over a large number of transactions.

negotiating and concluding separate contracts for each exchange transaction which takes place on a market must also be taken into account....A factor of production (or the owner thereof) does not have to make a series of contracts with the factors with whom he is co-operating within the firm, as would be necessary, of course, if this co-operation were a direct result of the working of the price mechanism. For this series of contracts is substituted one.¹²³ The same analysis can be applied to efficient background laws. Although Coase did not use the term, he was explaining that a firm can minimize transaction costs. Efficient background law should do the same thing. Instead of having to renegotiate the same contract terms over and over one is substituted.

"The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism. The most obvious cost of "organizing" production through the price mechanism is that of discovering what the relevant prices are. This cost may be reduced but will not be eliminated by the emergence of specialists who sell this information. The costs of negotiating and concluding a separate contract for each exchange transaction which takes place on a market must also be taken into account. Again, in certain markets, e.g. produce exchanges, a technique is devised for minimizing these contract costs; but they are not eliminated. It is true that contracts are not eliminated when there is a firm, but they are greatly reduced."¹²⁴

The cost of using the price mechanism is a transaction cost. The cost of negotiating and concluding a separate contract for each exchange transaction which takes place is one type of agency cost (contracting). There remains another cost, namely monitoring performance. Alchian and Demsetz refer to this "agency cost" as "the metering problem." The firm has the problem of metering productivity and metering individual employees.¹²⁵ Jensen and Meckling discuss the role of monitoring and harmonizing the interests of managers with the interests of the firm in order to reduce agency costs.¹²⁶ One way to reduce monitoring cost is through efficient contractual provisions which provide both monitoring and sanctions against shirking.

Another way of reducing these costs is through the provision of efficient background laws. Efficient background laws would be able to lower both the transaction and agency costs. Transaction costs could be lowered by standardizing certain contractual terms thus lowering the cost of negotiating a lower limit on contractual terms. Agency costs could be lowered if these same provisions made it unnecessary to hire specialists (i.e. lawyers) to handle simple or standard contracts through the creation of forms, under which the terms were inherently fair (fairness being a condition of efficient background law). Jensen and Meckling conclude that the "level of agency costs depends among other things on statutory and common law and human ingenuity in devising contracts."¹²⁷

b. Posner

Richard Posner states that one function of contract law (and other categories of background law) is to "economize on transaction costs by supplying standard contract terms that the parties would otherwise adopt by express agreement; it should be clear by now that the same is true with corporation law." In the area of company law Posner gives some examples of terms which lower transaction costs. These include: limiting the payments of

¹²³ Supra note 24 at 38-39.

¹²⁴ Ibid. at 33-56 and 38-39.

¹²⁵ A.A. Alchian and H. Demsetz, "Production, Information Costs, and Economic Organization", 62 American Economic Review 777-795 (1972) at 778.

¹²⁶ M.C. Jensen and W.H. Meckling, "Theory of the Firm: Management Behavior, Agency Cost and Ownership Structure", 3 Journal of Financial Economics 305-360 (1976) at 323.

¹²⁷ Ibid. at 357.

dividend to the amount of the earned surplus; granting limited liability to every corporation; minimum shareholder voting rights; and stipulating how the board of directors is to be elected.¹²⁸

Posner, along with Anthony Kronman indirectly points out that background law has one serious negative effect. By setting up minimum standards, it restricts the right of individuals to contract freely. Many of the restrictions have a rationale which is hard to refute. These include: not enforcing contracts where one of the parties agreed to the contract with a gun pointed at his head ('I will make him an offer that he cannot refuse'); not enforcing contracts made by children or incompetents; contracts in the restraint of trade (attempts to monopolize); contracts involving slaves; contracts to commit a crime; or contracts which alter the accepted rules of evidence or procedure.

They then ask whether the purpose of restrictive laws is to promote paternalism. "[A] limitation on an individual's freedom of contract is paternalistic if the sole purpose of imposing it is to promote or protect the individual's own welfare (or happiness or good). If a particular limitation is imposed in order to reduce the costs of the bargaining process (for example, by insuring its procedural propriety), or to protect the interests of third parties, it can be justified on non-paternalistic grounds."¹²⁹

The difference between efficient background law and paternalism can be a thin one. The only way societies can strike an efficient balance between these two conflicting and competing outcomes is through democratic representative government. This is the only forum in which this type of trade-off can reasonably be decided.¹³⁰

3. Striking A Difficult Balance

The creation of efficient laws requires striking a difficult balance: on one hand, there is the theoretical desire to allow every contracting party to negotiate for whatever he subjectively feels is in his own best interest; on the other there is the necessity to minimize the cost of achieving these goals. To the extent that certain outcomes are provided by background law which would have been arrived at by freely contracting parties, background law will always be efficient as transaction costs are minimized; to the extent that background laws lead to agreements which freely contracting parties would not agree to they are inefficient, unless there is some absolutely compelling public policy concern which overrides the legitimate concerns of the contracting parties.

Overriding public policy concerns can occur in several instances. In each of these three instances, background law simply provides a set of constraining parameters.¹³¹ (1) Chapter 1 outlined that efficient law would

¹²⁸ Supra note 27 at 372 and 384.

¹²⁹ A.T. Kronman and R.A. Posner, The Economics of Contract Law (Boston and Toronto: Little, Brown and Company, 1979) at 253-254.

¹³⁰ A referendum of course could also be used. The number of persons who had a direct stake in the outcome of the referendum on a background law might however be few and the issues involved might be highly technical, to the extent that voters might not care enough or have enough technical information to be able to weigh the arguments for each position properly.

¹³¹ Some of the parameters which public policy sets out can become outdated either through changes in morality or technology. Many years ago the Commonwealth of Massachusetts enacted a law which prohibited the lending of money for gambling purposes. The law was supposed to be used against loan sharks (See Chapter 1). In 1987, a Massachusetts resident went to Atlantic City to gamble. He lost \$8,000 - all of which had been advanced to him on his credit card through automatic teller machines (ATM) which the house had conveniently placed in easy to find places around the casino. When the gambler found that he could not repay the money he had lost, he sued his bank on the basis of the law which prohibited lending money for the purpose of gambling. This time lady luck was on his side. He won. The case is currently under appeal. If this case is upheld, for a while everyone with a credit card can go to the casino and play heads I win, tails you lose. "Plastic Losses" Newsweek (September

ensure that resources are fully costed. Since certain resources are not necessarily properly priced by the market, government intervention can be efficient, if the cost of government action is less than the benefits of the government action. (2) Government intervention could also be efficient if, as a result of the contract, negative externalities appear. Zoning law is a type of background law which may help prevent builders or operators using land in ways which interfere with the rights of others to enjoy their property. (3) Finally, there are public policy concerns that certain parties have access to more information or have more market power than the other contracting parties. In this instance the goal of background law is to narrow the information and power gap in order to ensure that parties are signing contracts similar to the ones they would sign if they had access to similar information or had similar bargaining strength. This use of background laws is a rejection, or at least a limitation, to the principle of caveat emptor.

Section 4: Conclusion

The purpose of this chapter was to point out that certain types of domestic laws can be more efficient than others. Certain types of laws can by themselves create conditions under which the rights of various parties can be determined in advance. This leads to certainty and risk minimization. If the parties' rights are set out in ways which maximize aggregate satisfaction these laws are efficient. Efficient laws will also limit the likelihood of opportunistic behaviour (one group or individual benefiting at the expense of lowering societal satisfaction). Finally efficient law will lower the levels of transaction and agency costs. Lowering agency and transactions costs in various countries will be taken up again in Chapter 4.

Chapter 3: *National Economic Styles*

Abstract

In the past many discussions on the differences between national approaches have centred on differences over political philosophy. This certainly has been true in the European Economic Community, a group of 12 democratic, neighbouring countries who share a basic commitment to the paternalistic state based on market principles yet approach problems and issues from many different directions. Differences in political philosophy are therefore not usable indicators in predicting how member states will react to European Commission proposals. A better explanation will be based on a discussion of the importance of national economic styles. This chapter defines what constitutes a national economic style and points out its importance. In doing so it down-plays the economic relevance of the active debate over political and economic philosophy. The chapter argues that although many past differences between member states have been discussed in the context of a political spectrum, a better analysis of the different approaches toward the community would be in the context of differences in national economic styles. The main purpose of this chapter is to lay the groundwork for Chapter 4, on national economic styles and efficiency, and Chapter 8, on the conditions when laws should be harmonized. The introduction of the concept of a national economic style is crucial to understanding why countries act in various fashions to achieve similar ends. It will be argued that different national economic styles create different national satisfactions, and costs and benefits. If the purpose of an action is to achieve efficiency, different means (in the form of markets and legal norms) will have to be used, in order to account for different national economic styles.

Chapter 3: National Economic Styles

"Europe [before 1500] had *always* been politically fragmented, despite the best efforts of the Romans, who had not managed to conquer much farther north of the Rhine and the Danube; and for a thousand years after the fall of Rome, the basic political power unit had been small and localized, in contrast to the steady expansion of the Christian religion and culture....For this political diversity Europe had largely to thank its geography....For a start, it both made difficult the establishment of unified control, even by a powerful and determined war lord, and minimized the possibility that the continent could be overrun....Conversely, this variegated landscape encouraged the growth, and continued existence, of decentralized power, with local kingdoms and marcher lordships and highland clans and lowland town confederations making the political map of Europe drawn at any time after the fall of Rome look like a patchwork quilt. The patterns on the quilt might vary from century to century, but no single color could ever denote a unified empire....The political and social consequences of this decentralization, largely unsupervised growth of commerce and merchant and ports and markets were of the greatest significance....If [post-World War II] Europe was to have a leader and spokesman, France was a more obvious candidate than the isolationist British or the subdued Germans. Furthermore, successive French administrations quickly recognized that their country's modest real power could be buttressed by persuading the Common Market to adopt a particular line....[n]one of this restrained France from unilateral actions when the occasion seemed to merit it."¹³²

Chapter 1 focused on the natural relationship between laws, markets and efficiency in a theoretical manner. Even though limitations were placed on what could be seen to be legitimate government behaviour or expenditure, no specific proposals for an efficient market or an efficient law were made. Chapter 2 described what efficient domestic laws should try to accomplish. The reason why no particular law was described is that any attempt to draw specific conclusions on efficiency calls for measurements which are not universal. Measures which would optimize satisfaction are necessarily individual or societal.

There is considerable dispute on a country to country basis as to what policy objectives laws should attempt to realize. The following appraisal demonstrates that, at least among lawyers, there is little comprehension of the relationship of law and policy, let alone the connection between laws, markets and efficiency. Even amongst people who understand the connection between law and policy, few understand that issues must be approached in different manners and may require different solutions on the part of different countries.

"[Many] lawyers still react with unease or even distaste when invited to view the law as an instrument of policy, and even those who find nothing strange about the notion will readily admit that the relationship between law and policy remains a problematical one. What problems lawyers perceive seems to depend a lot on where they come from. For the English - to start at home - the main problem is of the law's use as a vehicle of arbitrary power, or of 'policy without law.' The Germans - or some of them - worry about 'Verrechtlichung', and assume that everyone else does too. Among Francophones, one's allegiance as a public or private lawyer appears to be an important factor: while public lawyers are concerned about the law's inefficiency as a control mechanism, private lawyers are more inclined to fear 'legislative inflation' or the decline of 'droit' in the face of 'loi'; a decline which appears to correspond to Weber's 'materialization of law.' American concerns focus on the regulatory process, which some hold to be in 'crisis' and others would restrict or dismantle, though there remain voices asking for more extended legal ordering of governmental action....[This may] suggest the existence of a series of different national sets of problems with the law/policy relationship, and the futility of grand generalisation about it."¹³³

¹³² P. Kennedy, The Rise and Fall of the Great Powers (New York: Vintage Books, 1989) at 17-19 and 428.

¹³³ T. Dainith, "Law as a Policy Instrument: Comparative Perspective", in T. Dainith (ed.), Law as an Instrument of Economic Policy: Comparative and Critical Approaches (Berlin and New York: Walter de Gruyter, 1988) pp. 3-55 at 4-5.

This chapter intends to focus on why different countries often approach common matters differently. The first section of this chapter points out the importance of national borders and demonstrates how governments influence economic decisions. The collective effect of these influences will be defined in terms of a national economic style. The second section focuses on the economic relevance of the debate over political philosophy. The chapter concludes with a discussion of the limitations of traditional political and economic philosophy when discussing why countries have different responses to common issues, especially to European Community policy proposals.

Section 1: National Economic Styles

Since the concept of a national economic style is not self-apparent, it has to be developed. Before defining the term, this section will show the importance of national style differences, outline how governments influence economic decisions, and finally define a national economic style in terms of both inputs and outputs.

1. National Style Differences

To illustrate how important national borders are to economic policy, this chapter will begin by diagnosing a field of science which is not generally considered to be economically based: health care. Many people perceive medical practice to be a science which operates on the cutting edge of technology. Information regarding new treatments, cures, medicines and techniques flow quickly over the entire globe, relatively oblivious to national boundaries. One would expect, even if health care were financed in different manners, that the provision and the amount of health care would not differ greatly. But it does, and not necessarily due to a lack of information, a lack of money or because of the inertia in the health care system alone. Surprisingly to a casual observer, the amount, manner and form of health care which one receives even in the richest countries differs widely.

"Even the styles and fashions of medical practice observe national boundaries. Organ transplants are all but unknown in Japan; births by caesarean section are as common as natural childbirth in Los Angeles; what is a pill in Britain is often a suppository in Belgium. But the biggest difference between countries lie in the way that care is delivered and financed. In Britain, for instance, it is mostly paid for out of taxes and provided for in state-run institutions by salaried staff. In America it is usually paid for by private insurance and delivered in private institutions by fee-earning staff. Other countries have 57 confusing varieties of taxes, social insurance, patient charges, private insurance, public and private hospitals, doctors who work for, work in or even own clinics."¹³⁴

If services such as health care, which one would expect to be dominated by medical fact and technical possibilities rather than local custom, are delivered in different and conflicting manners, it seems reasonable to ask whether different approaches to common issues faced by various governments can be equally efficient. If two or more approaches can be deemed to be equally efficient, this should effectively refute any ideas regarding a universal standard of efficiency. The issue of efficiency in this context will be extensively analyzed in Chapter 4.

However, a preliminary answer to the question of whether two different solutions to common problems can be simultaneously efficient is derived from the analysis contained in Chapter 1. "[V]arieties of taxes, social insurance, patient charges, private insurance, public and private hospitals, doctors who work for, work in or even own clinics" are all differences in legal norms which can and do create radically different markets. Any and all of the various markets may be efficient if these differences in legal norms maximize aggregate satisfaction. As a result, it is argued that the seemingly neutral concept of efficiency is not a universal standard. The concept of

¹³⁴ J. Peet, "Surgery Needed: A Survey of Health Care", *Economist Survey* (July 6, 1991) at 3-4.

efficiency should be judged at a national (or a more regional) level. Various surveys of cultural differences have come to similar conclusions.¹³⁵

For the purposes of this discussion it is enough to recognize that, as the health care example points out, various countries have devised different approaches, styles and institutions which may create varying solutions to similar issues. These national approaches, styles and institutions help create radically different individual utility curves which create their own sets of transaction and agency costs. Collectively these differences will compel various countries to devise different approaches and solutions to problems they have in common. Whether these solutions are efficient is a separate issue. An efficient solution to the issue of health care must, however, take into account the preferences of the patients, the health care providers and those who pay for the health care. Since each country's approach, style and institutions have an obvious economic effect, they collectively form the basis of a "national economic style." The concept of a national economic style will be developed in the rest of this section beginning with an analysis of how governments influence economic decisions.

2. Determinants of a National Economic Style

a. Output: National Policies and Institutions

With different approaches towards constitutional issues, state regulation, law making, property rights and taxation, each country will necessarily affect economic decisions in distinct ways. In most Western countries, these approaches and policies are largely noncontroversial. While national political parties have different methods and means of achieving their political ends, most Western countries have come to substantial agreement in virtually every major policy area. The resulting policy agreements must be considered outputs. These outputs are important since they will affect market conditions (allocation and prices). They also indicate, in some respects whether the government or private groups or individuals are responsible for various actions. Collectively these affect individual and firm behaviour.¹³⁶

b. Where Consensus has Been Reached

In which policy areas has consensus been reached? One could argue that most Western countries have a broad national agreement on their basic constitution and structure of government, national defense issues, overall foreign policy, levels of social security, taxation policy, the method of the provision of health care, the educational system, the basic economic structure of the country and the provision of organizational structures. Together these policies form a coherent economic system which collectively creates a national fabric (and perhaps even a national identity) which forms the basis for a "national economic style."

¹³⁵ See R.M. Kanter, "The Boundaries of Business", *Harvard Business Review* 151-164 (May-June 1991). The Harvard Business Review in conjunction with 24 other publications polled 12,000 managers in 25 countries on 91 issues. The aggregate responses of managers of various nationalities were markedly different on virtually every question. The survey found that business leaders, long considered the chief proponents of free trade, cannot be counted on to oppose protectionism. While most managers in richer countries favoured free trade and thought they should be free to move facilities anywhere around the globe, many were even more adamant in supporting an active role for government in protecting their own interests. Most American, British and French managers advocated government help for domestic businessmen. Japanese businessmen, on the other hand, claimed to be strongly committed to free trade. South Korean and Indian executives are unabashed advocates of government coddling and local content rules. Only German managers rejected most forms of government protection.

¹³⁶ For an interesting discussion of how different countries provide different approaches toward the regulation of common problems and institutions and how individual and firm behaviour is affected see D. Vogel, *National Styles of Regulation* (Ithaca and London: Cornell University Press, 1986).

c. How to Measure Inputs

A simple definition of a national economic style is difficult. But since outputs were measured in terms of policies and institutions, we should also be able to measure the inputs. At the broadest level anything and everything which could possibly affect policy, institutions or thinking can be included. At the narrowest level, one must remember that nations are comprised of individuals and that individuals have varying and changing interests, tastes, values and preferences. By taking into account both the broadest and the narrowest levels, one could argue that the inputs are the aggregate interests, tastes, values and preferences of a society.

People of course also make a large difference. There are some "style makers" or "fashion leaders" who have a greater effect on public tastes, values and preferences than others. As politicians are supposed to simultaneously lead and follow national opinion, their relative effectiveness can be measured in terms of their ability to influence and reflect public opinion. People of different countries tend to reflect their national economic style - this influences how they view others. For example, unlike American managers, managers from Germany, Japan, Sweden, Italy and South Korea "seem curiously uninterested in teaching the world to emulate their practices. One reason is that these managers are usually more interested in emphasizing their uniqueness than in claiming the universality of their cultural perspective."¹³⁷

3. A Definition of a National Economic Style

Aggregate interests, tastes, values and preferences shape national institutions and policies. National institutions and policies in turn shape aggregate interests, tastes, values and preferences. A national economic style can thus be defined as the combination and interaction of interests, tastes, values, preferences, institutions and policies which have a substantial and measurable economic effect on a nation's conduct and behaviour.¹³⁸

Although there is some overlapping, the notion of a national economic style is quite different from national taste, culture or language. A cultural preference for either pills or suppositories; beer or wine; dubbed foreign television programmes or subtitled; one type of cheese over another; weak government or strong government; centralization or decentralization; or books translated into one's mother tongue or left in its original language, while possibly related to language or culture, will only affect the national economic style if they have a measurable economic effect.

Michael Porter illustrates why differences in national economic style are important and how they lead to misunderstanding. "The Italian success results from the match between a nation's unique environment and the source of competitive advantage in particular industries. The Italian success in fragmented industries and in competing with highly focused strategies, for example, draws on unique attributes of the Italian environment. Most commentators on the Italian economy persistently underestimated Italy, because they have applied

¹³⁷ C. Hampden-Turner, "The Boundaries of Business: The Cross-Cultural Quagmire", 69 *Harvard Business Review* 94-96 (September-October 1991) at 94-95.

¹³⁸ One should note that this definition of a national economic style differs substantially from both the old and the new German concept and definitions of a *Wirtschaftsstil*. In the old concept it was used by Schmoller, Sombart, Spiethoff and Schumpeter to indicate a term of economic sociology. See G. Schmoller, *Grundriss der Allgemeinen Volkswirtschaftslehre I & II* (Leipzig: Duncker & Humblot, 1923); W. Sombart, *Der Moderne Kapitalismus I-III* (Leipzig: Duncker & Humblot, 1916/1927); A. Spiethoff, "Die Allgemeine Volkswirtschaftslehre als Geschichtliche Theorie: Die Wirtschaftsstile" in A. Spiethoff (ed.), *Festschrift für Werner Sombart zum Siebenzigsten Wiederkehr Seines Geburtstages, Neunzehnter Jänner 1933* (Munich: Duncker & Humblot, 1933) pp. 51-84; and J.A. Schumpeter, *History of Economic Analysis* (New York: Oxford University Press, 1954). A newer interpretation, one which is heavily influenced by the definitions given by Sombart and Spiethoff, uses the term to help explain alternative economic conduct. See B. Schefold, "Die beiden Wege" in K. Meirer-Abich and B. Schefold, *Wie Möchten Wir in Zukunft Leben? Der "Harte" und der "Sanfte" Weg*, (Munich: Beck, 1981) at 133-162 and J. Backhaus, "Financing the Alternative Economy," 61 *Annals of Public and Cooperative Economics* 6-16 (1990).

American, German, or Japanese norms to an economy with a very different structure. National differences (in demand, skills, suppliers, and fields of educational excellence) are valuable.¹³⁹ Some of the consequences of the differences created by a national economic style will be elaborated upon both below and in Chapter 4.

Section 2: Political Philosophy Versus National Economic Styles

Most Western countries have a broad national consensus on their basic constitution and structure of government, national defense issues, overall foreign policy, levels of social security, taxation policy, the method of the provision of health care, the educational system, the basic economic structure of the country and the provision of organizational structures. Opposition parties, while generally thought of being either to the "left" or "right," tend to focus on issues of relatively marginal importance in terms of political philosophy. The opposition rarely fundamentally questions what the government is doing, it merely discusses mundane matters such as the distribution of costs and benefits, alternative financing methods, or minor changes in the degree of government intervention. Fundamental shifts in the degree or nature of governmental intervention are rarely discussed.

Since the political analysis considers the distribution of costs and benefits to be marginal to the 'real' issue of the extent of government involvement, the conclusion is drawn that contemporary political discussion reduces around the dividing of the spoils of government power, both political and financial. If allocation is made on the basis of power or political spoils (a type of bribery or pay-off), rather than ideological grounds, the effects should be viewed as pure "rent-seeking." Rent-seeking is the process of parties lobbying the government in the quest for special favours called economic rents.¹⁴⁰

I. Western Europe

With the notable exception of Greece (and perhaps Sweden), we have seen a vast narrowing of difference between the right and the left among the various Western European countries and between member states' political parties. Often it is difficult to articulate the basic difference in the political ends of the major parties in terms of a political spectrum. This is especially true in the most fundamental categories of national policies.

This raises an important problem for conventional economic analysis. First, if countries, individuals and political parties can be placed somewhere along a political-economic spectrum, it is logical to expect that similar political parties and individuals from different countries would hold similar views on similar issues and therefore recommend similar types of solutions to similar problems. Even amongst opposition parties, there is little enthusiasm in France for adopting German positions, in Spain for adopting Portuguese positions, in Ireland for adopting British positions, or in Belgium for adopting Dutch positions, or *vice versa*, in any of these major policy areas. This is true even if one does not agree that national consensus truly exist. Even if the Greeks do strive for the higher Danish standard of living, one sees little enthusiasm for adopting any of their economic institutions.¹⁴¹

¹³⁹ M.E. Porter, *The Competitive Advantage of Nations* (London and Basingstoke: Macmillan Press, 1990) p. 623.

¹⁴⁰ For a good overview of the ever growing field of rent seeking see C.K. Rowley, R.D. Tollison and G. Tullock (eds.), *The Political Economy of Rent-Seeking* (Boston, Dordrecht and Lancaster: Kluwer Academic Publisher, 1988). Note that rent-seeking rarely maximizes aggregate satisfaction. As a result, it cannot be considered to be efficient.

¹⁴¹ The Italian (and to a lesser extent the Belgian) position is different in important respects. While it is true that there are no loud voices calling for the adoption of the French or the German style, the Italians have become the most consistent and articulate voice calling for much deeper European unity. It has been argued that the reason is that the Italian government (as well as its society in general) would like a future European government to impose the type of governmental discipline and style which the Italians have either been unwilling or unable to impose on themselves, despite perceiving the need for

Furthermore, if political philosophy was the only determinant of government policy, one would expect to see governments with similar political philosophies recommending similar solutions to common problems. As mentioned in Section 1, countries cannot even agree on politically neutral questions such as how to deliver children or which medicines to take, conditions for providing health care, let alone on the size and the form of the social welfare system. Since a commitment to a paternalistic state based on capitalism has been more or less universally agreed to, one must look for a more complex reason to explain why countries analyze problems differently and often provide distinctive responses.

How then does one explain the European debate over a possible federal future, the powers of the Commission and the Parliament, subsidiarity, immigration, or a single European Currency? In these and other matters, it is necessary to rethink the relevance of the notion of a political spectrum and come up with an alternative explanation.

2. An Alternative Explanation: National Economic Styles

If neither national nor international debates focus on the role of the state in economic decision making, this focus does not explain fundamentally different approaches to common problems. A suitable explanation can be found in differences in the various national economic styles.

At the national level, once the national economic style has been fully developed, debate can and should centre on which mixture of policies and expenditures will maximize societal satisfaction. One can place this within the previous discussion of efficiency. Since there can be no certainty over which measures will maximize satisfaction, it is up to politicians to take measures which will tend to maximize it. In contrast to rent-seeking behaviour, this is a legitimate and necessary political action.

At the international level, when countries get together to discuss common problems they are often discussing apples versus oranges, as the health care example indicates. Countries, knowing what their national economic styles mandate, will generally only seriously discuss matters if there is no conflict between form (national economic style) and substance. Ideology usually plays little role in this exchange.

Section 3: Conclusion

Disagreements between Western countries have been mostly viewed in terms of political philosophy. This has been a mistake since this explanation fails to predict how countries will react to various international proposals. While there are certainly some cases where political philosophy is important in the European Community context (with Margaret Thatcher being the ideological odd-woman out in the 1980s), most of the disagreements between European Community member states should be analyzed in terms of differences in national economic styles.

When differences are analyzed in terms of national economic styles, attempts to harmonize European Community activities will be seen in a different light. An analysis in terms of a North-South split within the Community, in

it. It is curious that despite the impression that European control over their central governments will be a panacea, they are among the slowest implementors, and the most frequent violators, of European law. A. Martino, "Italy Moves No Closer to EMU" *Wall Street Journal Europe* (February 17, 1991) p. 8.

the coalitions for and against various proposals, policies, regulations and directives, is often fruitful.¹⁴² There are of course many exceptions. The split hinges more often on style than philosophy.

The differences in national economic styles have widespread economic effects as well. "It is not only that the diverse peoples of Europe speak different languages, that there are almost no books in common on their national best-seller lists, that cultural differences make pan-European advertising a flop. More than that, European nations have irreconcilable attitudes toward power, whether to get it, how to use it. They are divided by their histories."¹⁴³ Chapter 4 will discuss why countries have different approaches to common problems and why differences in national economic styles may mandate different efficient solutions.

¹⁴² The north is generally thought of as being comprised of Denmark, Germany, Luxembourg, the Netherlands and the United Kingdom. The south is usually thought of being comprised of the other seven member states. The divide is not totally geographic. Belgium and Ireland are further north than most of Germany, as is a large portion of France. Whether Austria and the Scandinavian states would act more like northern states or southern states is unclear. Even though these countries have strong socialist tendencies one should take into account that they would all be net contributors to the Community budget. Moreover, they rely largely on exports and support liberalized trade and have applied for membership at least partially in order to liberalize their own economies. This, plus their geographical location may in the end make them act more northern than southern.

¹⁴³ D. Brooks, "A Superpower Europe? Forget It", Wall Street Journal Europe (August 8, 1991) p. 10.

Chapter 4:
National Economic Styles
and Efficiency:
Why Countries Have Reacted
Differently To Similar Problems

Abstract

This chapter will argue that the concept of efficiency in the field of law and economics is not a universal standard, but should be judged at a national (or even a more regional) level. Various countries have different national economic styles (as defined in Chapter 3) which create various solutions to similar questions. These solutions may well be efficient (as defined in Chapter 1) if they tend to maximize aggregate satisfaction. National economic styles help create radically different individual satisfaction curves and different transaction cost configurations and agency cost structures. Collectively these differences may actually compel countries to devise different efficient approaches and solutions to problems they have in common. In many instances the solution to common issues will not be harmonization, but diversity.

Chapter 4: National Economic Styles and Efficiency: Why Countries Have Reacted Differently To Similar Problems

"Most countries are dealing with health care reform as if each was on Mars. Few have tried to learn from others. Many who are expert in the politics and economics of their own country's health systems know little about how things work next door....This indifference to the international face of doctoring is a huge mistake. This is not only because any one country has miraculously solved all of its problems, or because (say) Britain would do better to scrap its beloved health service and replace it with (say) Germany's. It is just that there are lessons to be learned from looking at different ways of paying for and delivering the goods. Instead of each country trying out its own experiments, they should be studying each other's for ideas and pitfalls."¹⁴⁴

Chapter 3 developed the concept of a national economic style. A national economic style was defined as the combination and interaction of interests, sentiments, values, preferences, institutions and policies which have a substantial and measurable economic effect on a nation's conduct and behaviour. These given national economic styles help create radically different individual satisfaction curves and different transaction cost configurations and agency cost structures. In Chapter 1 efficiency was defined as the use of the available resources in ways which bring about the maximum satisfaction possible, given the available technology. This chapter brings these two concepts together and is the central argument of this book. The second part of the book discusses how competition for investment and tax revenues may change the way of how nations should view what is efficient law.

The first section of this chapter focuses on national economic styles and discusses how these functions may add to or detract from national efficiency and why countries may have different solutions to problems they have in common. The second section discusses the relevance of national economic styles by demonstrating that each country has its own national satisfaction function, cost of inputs, equilibrium and transaction and agency costs and relates these functions to a concept of efficiency. The third section sets out an example of how different national economic styles can create different efficient solutions through an analysis of the market for investment in general and company laws in particular. The final section challenges the current property rights analysis by refuting the notion of a universal efficiency standard and sets out the proposition that varying national economic styles will create different efficient solutions which are only relevant on a national (or more regional) scale.

Section 1: National Economic Styles and Efficiency

The analysis of Chapter 3 showed that countries with similar ideological backgrounds can and often do have quite different approaches toward fundamental policy issues. The concept of a national economic style helps explain why neighbouring countries with seemingly similar political philosophies often reach different broad national policy consensus. Neither ideological spectrum nor the idea that nations are pragmatically approximating a common ideal of efficient governance can explain these differences. If there was a universal efficiency standard, it would be reasonable to conclude that discussions over similar issues would be based on similar arguments. This is not often the case. This is not to say that national debates are not coherent. They almost always are. It is simply that the arguments which are raging at the national level in any given country only make sense within the context of its national economic styles. As efficiency realization is often given as the final goal of policy arguments, it is important to analyze the national policy debates on a national subjective basis, not on an international objective basis. As Victor Goldberg stated: "Efficiency is contextual."¹⁴⁵

¹⁴⁴ J. Peet, "Surgery Needed: A Survey of Health Care" Economist Survey (July 6, 1991) at 3-4.

¹⁴⁵ V.P. Goldberg, "Relational Exchange: Economics and Complex Contracts", 23 American Behavioral Scientist 337-352 (1984) at 342.

Why is efficiency contextual? Countries have reacted differently to similar problems for three reasons:

1. Countries have gone through different historical experiences and have reacted to these problems in different ways. Correspondingly, institutions have been initiated in various countries at different times, under different conditions. When this is considered it is not surprising that different countries have varying styles of institutions.
2. Institutions are rarely completely overthrown or completely overhauled. Most institutions are formed by a gradual evolutionary building process over long periods. Changes are both incidental and incremental and are usually enacted to remedy some perceived failure. Even if the initial reaction of two countries to a shared problem was similar, it is unlikely that subsequent reform measures would consistently address similar problems in standard ways.¹⁴⁶
3. As economies are internally balanced and a change in one area will have ripple-effects on other, often seemingly unrelated areas, most governments' policies end up being internally consistent over time.¹⁴⁷ Even if the resulting institutions cannot reasonably be regarded as "efficient," the cost of reforming them may be far greater than the cost of retaining them, especially in the short term. This excessive cost may arise from how the reform would disrupt other seemingly unrelated areas, rather than the cost of reforming the "inefficient" institution under consideration.

One may argue that the maintenance of and building upon established institutions and practices merely demonstrates an acceptance of the *status quo*, but to state that issues of a national economic style can be explained by culture misses an important point: cultural differences will have an important economic effect. Different national economic styles will also dictate that efficient public policies vary on a country by country basis.

Section 2: The Relevance of a National Economic Style

a. National Satisfaction

Each country has a particular *national economic style* which has developed according to the ideals and goals of its people and the accidents of history. In pure economic terms, a national economic style might be defined in terms of a collective national satisfaction. In a democratic country, this satisfaction is somehow mirrored, however imprecisely, through the elective and public choice process. Collective national satisfaction expressed in terms of efficiency is different and more fundamental than most public choice research indicates.

Most public choice research focuses on how decisions are reached in different countries or why certain public expenditures are made. For the purpose of this analysis, it is taken as a given that people already have certain values and that these values are reflected, even if imperfectly, in their choice of elected representatives and their institutional and public spending preferences. It is also assumed (even though experience often proves otherwise) that public policy seeks to optimize national satisfaction, given the society's collective notion regarding optimality of production, distribution and wealth. If these values are correctly reflected in a country's constitution, laws and

¹⁴⁶ This can broadly explain why former colonies often have different national solutions, but similar basic institutions as their former rulers/occupiers.

¹⁴⁷ The issue of internal consistency can explain why, when people of different countries meet to discuss a single problem, they instinctively use their own country's experience to illustrate why their country handles the issue in a proper manner. They conclude by mentioning that because it works in their country it should work everywhere. It should come as no surprise that people of other countries rarely reach the same conclusion as the speaker. Most listeners just smile and roll their eyes and later go on to use their country's example to illustrate a better way to approach the problem. This offers a fine example of why economic analysis is usually better when it is descriptive as opposed to prescriptive.

regulations, they will promote national efficiency. By definition, if they are not reflective of the collective precepts of production, distribution and wealth, the aggregate collective satisfaction cannot possibly be achieved.

b. Costs of Inputs

Countries will achieve efficiency in different ways because the costs of their inputs are often radically different. Efficient government policies will also reflect these costs. To simplify matters, this discussion will be limited to the inputs of labour, capital, national infrastructure, and natural resources (including the environment).

Laws, regulations and tax policies greatly influence the supply and the cost of labour. The supply of labour is directly influenced by such factors as the levels of individual income tax, social security payments and contributions, the cost and availability of transportation, retirement ages and pension benefits, the availability of child care, the amount of training and the regulation of operating hours. The demand for labour is influenced by such factors as minimum wages, social security contributions, various labour regulations, the education level of the work force, the cost of training, the cost of capital and the health insurance scheme.

The cost of capital will depend on factors such as the size of the government deficit, the efficiency of the capital markets, governmental monetary policy and taxation policy. Taxation policy includes individual and corporate tax rates, the deductibility of interest and dividend payments, depreciation policies and investment incentives.

The availability of national infrastructure and resources will affect and should be reflected in the cost structure. As governments either own, operate, maintain or regulate virtually every type of infrastructure it clearly has an effect on the availability and degree of its supply and cost. Governments generally tax, own and regulate national resources. They also have the power to tax and regulate the usage of the environment. This overall taxation and regulatory power is used by governments to foster different policies. These policies will determine the cost and the availability of both the inputs and the outputs of a society. Proper pricing can facilitate optimal resource allocation.

c. Equilibrium

Most governments' policies end up being internally consistent over time. All the varying costs as outlined above will create different cost structures. The given cost structures may effect the usage and availability of resources. These cost structures are not static. These costs will radically affect both supply and demand conditions. Overall this leads different countries toward different equilibria.

In this context one should think in terms of a national internally balanced economy where a change in one law or institution will have a dynamic rippling effect on other, often seemingly unrelated areas.¹⁴⁸ If the premise that a nation's economic style creates internally consistent policies and institutions is correct, one can think of the resulting balance as a full equilibrium. It is important to understand that few economies have created institutions and policies in a vacuum. They have a dependence and an impact on other institutions and policies. If one major policy is disrupted, it will necessarily have an effect on others. If the disturbance is too large, it is possible that the proposed change may not be efficient, even if this change would in another country help bring about efficiency.

Often a change in one institution is proposed in order to take care of more than one problem. This solution often demands a counter-balance. For example, if there is high unemployment and societal and financial costs from having an abundance of idle 17 year old school leavers, a government may increase the minimum school leaving

¹⁴⁸ Jagdish Bhagwati makes this point in a different way in stating that even what he calls directly unproductive behaviour can sometimes be productive in counties with severe and widespread price distortions. In other words, some economies are so distorted that it can make sense to throw resources away as the alternative might be to use them in an even more damaging way. This type of efficient behaviour is not (and probably cannot be) expressed in any universally acceptable concept of efficiency. "Directly Unproductive, Profit-Seeking (DUP) Activities," 90 *Journal of Political Economy* 988-1002 (1982).

age to 18. This one action has many consequences. The obvious effect of this action is that national spending for education must be increased. This increased spending will increase the need for teaching staff, administration and school space. It will also initially decrease spending power, social security and income tax revenue as fewer 17 year olds will be working, decrease the crime rate as fewer people are idle all the time, alter property costs and property tax revenues, and remove the teachers and administrators from alternative activities. In the long run it may also increase the tax base by increasing the potential lifetime earning ability of the students. The issue of the resulting cost to the social security system depends on the rules of the system itself. In some countries a person has to have actually worked to be eligible for benefits. In others he is unconditionally entitled to social security benefits. Each of these results has economic and societal consequences. Each of these changes will initially affect the microeconomic climate to some degree and create a disequilibrium. These changes alter the economic balance and a new societal equilibrium will eventually be achieved.

d. Transaction and Agency Costs

As Kenneth Arrow put it, transaction costs are the "costs of running the economic system.... [Such costs] impede and in particular cases completely block the formation of markets."¹⁴⁹ As far back as 1934, John R. Commons recognized that although conflicting interests among parties to a transaction were assumed to be natural, the transactions were not taken as fixed. To the contrary, the object was to devise institutions that served to harmonize interests or at least to achieve order where otherwise there would have been conflict.¹⁵⁰ Different countries have different national economic styles. As a result of these style differences there are different transaction costs and structures. As Commons said, transaction costs are not fixed. Different national economic styles impose different transaction costs. Alternative systems and structures may be necessary to take into account these differences. If the institutions are to be efficient, different structures may even be mandated.

Attention is thus focused less on technology, which today flows relatively easily across borders, than on the comparative costs of planning, adopting and monitoring task completion under alternative forms of contracting.¹⁵¹

1. Taxes

Taxes impose varying levels of transaction costs. Whether a certain type of tax is efficient is a function of the perceived merits of the tax, the propensity of people to avoid paying the tax and the taxes' cost of collection. Even though, in principle most people agree on the need for environmental taxes, petroleum taxes and excise taxes on alcohol and tobacco, different countries tax these goods at a wide range of rates (if at all). Countries will also have different collection methods which vary according to the cost of collection and the propensity to avoid payment. These various methods reflect the differences in agency and transaction costs. Depending on the national economic style, each of these taxation systems may only be efficient within its own context.

2. Governance Structures

Williamson helps make a critical link in his analysis of governance structures. Williamson treats all people making exchanges in a market place not as individual exchangers, but as if they were a single maximizing unit.¹⁵² Since all citizens of a country live under a system of national laws and, as indicated in Chapter 1, laws are the basis upon which markets are created, the Williamson approach can be used by saying that all

¹⁴⁹ K.J. Arrow, Essays in the Theory of Risk-Bearing (Chicago: Markham Press, 1969) at 48.

¹⁵⁰ J.R. Commons, Institutional Economics (Madison: University of Wisconsin Press, 1934).

¹⁵¹ O.E. Williamson, "Contract Analysis: The Transaction Cost Approach," in P. Burrows and C.G. Veljanovski, The Economic Approach to Law (London: Butterworths, 1981) at 40. One should note that these are all functions of management.

¹⁵² O.E. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" 22 Journal of Law and Economics 233-261 (1979).

citizens of a country make exchanges in a common marketplace. The citizenry can be thought of as a single unit, since in democratic countries they hire agents directly (elected officials) or indirectly (regulators and civil servants)¹⁵³ to create the rules of the marketplace. The issue now boils down to discovering how a single maximizing group organizes itself efficiently.

3. Societal Trust

Another element reflected in a nation's *economic style* is the degree of trust and the amount of consultation needed to promote societal harmony.¹⁵⁴ The embodiment of social harmony will differ from country to country since the wants and needs of individuals, labour, industry, government, religious groups, and interest groups may differ dramatically. As groups will differ according to the level of trust, coherence and the general temperament of their members, the amount of consultation required to achieve a decision will vary. These costs will be reflected as contracting costs when agreements are being formed and formalized and as agency costs when the parties determine whether the other contracting parties are living up to their agreements.¹⁵⁵ The interrelationship between the contracting cost and the monitoring cost will determine whether certain political, consultative or monitoring institutions are economically efficient.

The lack of a universal transaction and agency cost structure can be illustrated by three examples.

d. Example 1: Centralized versus Decentralized Decision Making

In the Netherlands, decisions are often not taken until anyone and everyone who might conceivably be affected by a decision has had the opportunity to be heard. The decisions taken are formed by a general consensus. As a result the decisions taken are often very narrow and conservative. In France, decisions are often taken only by the person(s) at the very top of an organization. As a result the decisions taken can be broad and daring.

Since this analysis is concerned with the relationship between the cost of contracting and the cost of monitoring, it would not be surprising if the cost of contracting will be higher in the Netherlands and lower in France. The reason why this can be predicted is that while fast and clear decisions can, at least theoretically, be taken in France, the time and the number of people involved to take decisions in the Netherlands will theoretically be higher. The costs of contracting will usually be higher in countries where group decisions are required than in those where power is placed in relatively few hands.

Correspondingly, the amount of monitoring or agency costs will usually be higher in those countries where power is placed in relatively few hands. Since everyone in the Netherlands should feel that he had the opportunity to be heard, and at least tactically agreed with the decision taken, it is unlikely that anyone will try to scuttle the agreement after it has been made. Moreover the opportunity for any small group or individual to unduly profit from the agreement without the consent of the others is limited. As a result, monitoring costs should be low in the Netherlands. In France on the other hand, the narrow group of decision makers had the opportunity to cut a deal which benefited either themselves or others who they favoured. Additionally, if the decision was bold it may have created discord amongst the people whose cooperation is necessary to implement the decision. As a result a great deal of monitoring may be necessary in France.

It should not be surprising then that the Netherlands, where widespread consulting is done before a decision is taken, will have different types of institutions and structures than France where decisions are made by smaller

¹⁵³ Regulators and civil servants are either directly appointed by direct agents or hired according to the civil service regulations promulgated by regulators or elected officials.

¹⁵⁴ Kenneth J. Arrow stressed the role which trust plays in a successful economy in The Limits of Organization (New York: W.W. Norton, 1974).

¹⁵⁵ The relationship between contracting and monitoring was made by Ronald Coase in "The Problem of Social Cost" (1961). Reprinted in The Law, The Market and The Firm (Chicago and London: University of Chicago Press, 1988) at 114.

groups. The efficient structures in the Netherlands will concentrate on the decision making process; while corresponding efficient structures in France will attempt to provide adequate monitoring.¹⁵⁶

e. Example 2: Litigious versus Non-Litigious

In the United States, working relationships are only formed after formal contracts have been negotiated. In Saudi Arabia, working relationships are formed through the development of friendship. Written contracts are rarely necessary, as a man's word binds him, and a piece of paper is after all only a piece of paper.

One would expect that widely different transaction (and agency) costs will be reflected in the cost of drawing up a contract, the risk and cost of legal proceeding and the steps necessary to monitor and enforce the contract. If the risks and costs of law suit in America are high relative to Saudi Arabia, individuals and firms will be more insistent that contracts are explicit and well defined with every 't' crossed and 'i' dotted.¹⁵⁷ As a result the cost of contracting will be relatively high in America. If the risk in Saudi Arabia is low, contracts will not have to be explicit and a simple handshake might do in some instances. If the relationship is strong enough often such important matters as price, quantity and time and place of delivery may not even be discussed.

Correspondingly, while it takes a great deal of time, energy and money to contract in the United States relative to Saudi Arabia, the cost in time and energy to fill in the details and make sure that the terms of the agreement are carried out should be higher in Saudi Arabia than in the United States. The level of agency costs required to monitor the contract will usually be higher in places where the terms of the contract are not explicit. Additionally, there is less need to monitor an explicitly drawn up contract where the cost of noncompliance is high than is the case where certain terms were left ambiguous and the penalty for perceived noncompliance is low. The chances of ensuring that the terms of the contract are lived up to should correspond to the cost of not adhering to the terms of the contract.

It should not be surprising that there are strong economic reasons (stemming from differences in the national economic style) for having different institutions and working protocols in the United States than in Saudi Arabia. Efficiency criteria will compel different countries to have alternative types of consultation structures and monitoring arrangements which clearly reflect these relationships.

f. Example 3: Long-Term versus Short-Term Contracting

In Germany, companies tend to engage in long-term contracting with employees, shareholders, banks, customers and suppliers. In Great Britain, companies tend to engage in shorter term relationships. As a result, German companies will be able to adopt a strategy with a longer time-horizon and pay-back period than a British company. The length and type of contracts will have an effect on the type of risks which each firm and its contracting party will be willing to take. The longer the term of the contract the greater the level of planning, risk and investment which can be undertaken. Firms with a longer term outlook and a secure line of credit from a bank or a group of companies which owns a large portion of its shares and has a position of prominence on the Board of Directors should be better able to hedge and diversify since the presence of longer term contracts acts as a form of insurance; the position on the board allows the bank or the group to monitor the performance of the firm.¹⁵⁸ The shorter the term of the contracts, the greater the inability to hedge on risks. The lack of a long-term supply of credit provides its own monitoring function; if the firm is unable to adapt quickly it will

¹⁵⁶ In a similar vein, P. D'Iribarne has noted the importance of well-defined roles and responsibilities in French versus Dutch factories. *La Logique de l'Honneur* (Paris: Seuil, 1989).

¹⁵⁷ One additional contracting cost can be the cost of procuring insurance which may come in various forms, i.e. performance bonds, surety bonds or litigation insurance.

¹⁵⁸ R. Jankowski, "Preference Aggregation in Firms and Corporatist Organizations: The Enterprise Group as a Cellular Encompassing Organization", 33 *American Journal of Political Science* 973-96 (1989).

have extreme difficulty in securing future credit and suppliers.¹⁵⁹ This creates great pressure on managers to succeed.

The type of contracting and of monitoring may well be different in firms in each country. Each would result in a characteristic cost structure. One would expect the German companies to be party to fewer contracts over time. Since the contracts are for longer terms, the terms of the contract will have to be more flexible than in the British case, in order to take into account changes in circumstances which arise over time. The type of monitoring required to oversee long term contracts with flexible provisions is different to the monitoring required for shorter term specific contracts. Shorter term specific contracts should require a great deal less monitoring. As firms are formed precisely on the basis of these types of contracts (for the reasons covered in Chapter 2), one would expect to see different types of corporate structures both to engage in contracting and to provide the monitoring in each country.

g. Example 4: Working to Live versus Living to Work

In Israel, people generally work to live. In Japan, people generally live to work. In Israel, workers are largely independent contractors who show up for work for their pay check and will almost certainly leave for a better job or opportunity. The company will be quick to lay off workers (if it can) in the event of an economic slow down. In Japan, the workers' lives are organized around the firm and their co-workers. Workers are hired in the expectation that they have been found their life's work. The company which they work for is paternalistic. As firm-specific investments are high, fellow workers will exert enough peer pressure to lower monitoring costs. In Israel, as loyalty is not mutual, monitoring costs are higher.

Section 3: The Market For Investment: A Case Study

As will be seen in the second part of this book, governments are engaged in an international market for investment. Most governments try to provide an attractive climate for investment. This is true for both foreign and domestic investment. In the absence of capital controls, investment will be made in the place where it will make the greatest return, at a given risk level.

Notwithstanding attempts to seek and obtain economic rent, democratic governments will usually attempt (if not always successfully) to act in ways which further their national economic interests. Even if they do not on their own do this, it is certain that if entrepreneurs see opportunities to help their own competitive position, assuming low transaction costs, they will try to exploit them. If organizational laws are viewed to be inadequate, entrepreneurs should ask governments to provide them with ways in which they can compete with both domestic and foreign competitors. Institutions exist to make the transaction costs for doing so low.¹⁶⁰

¹⁵⁹ S.C. Schneider and A. De Meyer, "Interpreting and Responding to Strategic Issues: The Impact of National Culture", 12 *Strategic Management Review* 307-320 (1991) at 309-10.

¹⁶⁰ The existence of Chambers of Commerce and the possibility of cost spreading through the Chamber should allow transaction costs to be amortized over a large number of firms making them very low, especially if membership dues have already been paid. This means that the costs of obtaining suitable operating structures should be fairly low.

a. Company Law

Take for example the institution of company laws. Company law may be thought of as a special case from a public choice point of view because it is one area of law where nations are especially constricted on how they may regulate firms, since they know that the provision of company forms (and other types of background law) may affect their ability to attract and maintain investment in an international market for investment. If one accepts this premise, each country in this international competitive market has a vested interest in creating company and other background laws which facilitate an "optimal" allocation of labour and capital.

What is striking is that even in this international market for investment, each country has adopted its own, often fundamentally different, company law. To analyze these laws adequately, one should at least start with the assumption that these different company laws seek to achieve optimal resource allocation. Optimal resource allocation, taking into account all the laws and regulations which alter the supply and demand for capital and labour outlined above.

In establishing a company law, government institutions should consider all the groups with a specific interest in the regulation of a company. These groups include managers, shareholders, employees, creditors and the government itself. If any of these interests has been given undue consideration efficiency will surely not be obtained. Therefore, governmental institutions should take great care to provide operating structures which promote efficiency within their borders.¹⁶¹ In doing this they have to maximize societal satisfaction and permit firms to organize in manners which not only promote the micro-economic idea of economic efficiency in resource allocation and the macro-economic objective of maximising a country's potential output, but also to minimize transaction and agency costs. As demonstrated above, transaction and agency costs may vary on a country by country basis. This may help explain why laws are different; if they were not, these laws might not be efficient.

What one can conclude from this is that most, if not all, countries have enacted laws which they perceive to be economically efficient. If these laws are not economically efficient, legislators have acted in a manner which is contrary to their own best interests - which is to promote efficiency and increase the tax base. The fact that such a great deal of diversity is found could logically lead one to the conclusion that efficiency has, notwithstanding universal economic theory, been reflected and codified in national constitutional structures which were formulated in order to minimize aggregate transaction and agency costs and maximize overall satisfaction. If this is indeed what has been accomplished, one can conclude that efficiency standards and transaction and agency cost levels are not universal.

The lack of activity and change in company laws should be contrasted with the last decade's worldwide downward spiral in corporate income tax rates. This worldwide drop in corporate tax rates demonstrates that governments react to international competitive pressure to both attract and keep investment capital. Competitive pressure for tax revenues in an internationally competitive market will be the focus of Chapters 6 and 7. But if countries engage in this competitive process for tax revenues, it is reasonable to conclude that they also try to compete in the areas of law which involve investments.¹⁶² The resulting plethora of company laws and company structures should demonstrate that various countries may well have good and sound reasons for adopting their own version of a company law with different operating structures. If one accepts that this process might happen in the real world there are some serious problems with the current structure of the firm analysis.

¹⁶¹ J. Backhaus, "Efficient Statute Law" in M. Faure and R. van den Bergh (eds.), Essays in Law and Economics: Corporations, Accident Prevention and Compensation for Losses (Antwerp, Apeldoorn: Maklu, 1989) at 23-32.

¹⁶² Romano outlines how the American State of Delaware supplies company law on a competitive basis in Romano, R., "Law as a Product: Some Pieces of the Incorporation Puzzle", 1 Journal of Law, Economics & Organization 225-53 (1985).

b. Current Legal Structure of the Firm Analysis

Building on the work of Klein, Crawford, and Alchian,¹⁶³ Williamson,¹⁶⁴ Prescott and Visscher,¹⁶⁵ Grossman and Hart,¹⁶⁶ Milgrom¹⁶⁷ and Furubotn,¹⁶⁸ Gifford built a theory of the firm in which contracting is costly and the participants in the firm make firm-specific (or at least partially non-salvageable) investments.¹⁶⁹ He then builds on the assumptions in the theories of Prescott and Visscher¹⁷⁰, and Milgrom¹⁷¹ which state that contracts within a firm are interdependent. A firm is not just a collection of bilateral contracts; it consists of individuals bound together by interdependent long-term contracts. These interdependent contracts are designed to protect the investment of the members of the firm.

This type of analysis could be extrapolated to state that members of a society are also linked by long-term contracts. These long-term contracts are linked and have an internal consistency expressed in the national economic style. Individual members of society invest in this internal consistency and build up "country-specific" investments which take into account a country's way of doing things. This "country-specificity" must be taken into account when trying to create efficient structures and procedures because many of the costly contractual relationships are only relevant in their societal context. In the context of Efficient Law, this extrapolation leads to conclusions which are quite different to those of Gifford and Furubotn.

Gifford states that "[t]he constitution can be thought of as a set of interdependent explicit and implicit contracts between the owner of the firm and its various members, as well as the mechanism for monitoring and enforcing these relationships".¹⁷² Notwithstanding his apparent misunderstanding of the role which background law plays in a firm's contractual relations (as described in Chapter 2), taking Gifford's observation (derived from Furubotn)¹⁷³ regarding firm-specific investments to its logical conclusion, one would expect that each firm should develop its own independently determined constitution to formalize the relationships. He makes no such argument. He could also come to a similarly logical conclusion that firms in the same industry (regardless of nationality) might have similar relationships, requiring similar constitutions. Again, he does not make this argument. Some commentators, Furubotn in particular, take Gifford's argument in order to reach conclusions on the type of constitution that firms should have.

¹⁶³ B. Klein, R.G. Crawford and A.A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process", 21 Journal of Law and Economics 297-326 (1978).

¹⁶⁴ Supra note 9.

¹⁶⁵ E.C. Prescott and M. Visscher, "Organizational Capital", 88 Journal of Political Economy 446-461 (1980).

¹⁶⁶ S.J. Grossman and O.D. Hart, "The Costs and Benefits of Ownership", 94 Journal of Political Economy 691-719 (1986).

¹⁶⁷ P.R. Milgrom, "Employment Contracts, Influence Activities, and Efficient Organization Design", 96 Journal of Political Economy 42-60 (1988).

¹⁶⁸ E.G. Furubotn, "Codetermination and the Modern Theory of the Firm", 61 Journal of Business 165-181 (1988).

¹⁶⁹ A. Gifford, Jr. "A Constitutional Interpretation of the Firm", 68 Public Choice pp. 91-106 (1991).

¹⁷⁰ Supra note 22.

¹⁷¹ Supra note 24.

¹⁷² Supra note 26 at 104.

¹⁷³ Supra note 25.

Furubotn uses the same type of argument which Gifford makes and comes to the conclusion that a type of governance structure implemented through amendments to company laws known as co-determination (which is mandated for large German companies) is preferable. Under German co-determination there are two boards. At the highest level, there is the board of directors. Its mandate is to create policy objectives in order to enhance the long-term interest of the company. It is comprised of representatives of the shareholders and representatives of the workers. Depending on the type of company workers representatives comprise from one-third to one-half of the members of the board of directors. The employee representatives may not be trade union leaders.¹⁷⁴ The second board is the board of management. The board of management is responsible for the day-to-day management of the company. The members of the board of management are selected by the board of directors. The theory goes that since the employees have a say in selecting managers, they will only approve managers who take into consideration the welfare of the workers. This process, along with works councils, in turn helps facilitate communication which benefits the management of the company. Furubotn argues that this type of company tends to formalize the commitment of the company to the workers whose market value is at least partially comprised of firm-specific skills which have been derived from their firm-specific investments.

Those who advocate this type of corporate structure must answer this question: If this structure is so efficient, why have firms not unilaterally adopted co-determination in other countries? Why is that many German companies have operating structures which are designed to avoid co-determination?¹⁷⁵ And specifically in the case of a German investor, why is there no clamour amongst German investors in Spain to adopt the German corporate structure given their first-hand knowledge of the alleged efficiency of co-determination.

d. Capital Markets

Before offering an alternative explanation regarding the current theory of the firm, it is interesting to consider the role that capital markets may play in this process. In the trade-off regarding the interrelationship between the various stakeholders in the firm as described in Chapter 2, we would expect share prices to be highest in the instances where shareholders have the greatest amount of control over the company, all other things being equal. Share price is not only a concern to shareholders, it is also of importance to the other corporate "stakeholders." Higher share prices mean that investment capital in the form of equity can be raised at a lower cost. Higher amounts of equity lowers the amount of risk to lenders. Lower risk means lower interest payments. A lower cost of capital means that more investments will have a positive net present value. This in turn means that more investments will be made. These investments create economic activity, wealth and jobs. In order to overcome this strong argument for shareholder rights one must conclude that the advantages of passing control from the shareholders to other stakeholders must outweigh these benefits. In an international capital market the benefits must come either in the form of higher profits or substantially reduced risk.¹⁷⁶

¹⁷⁴ Trade unions are in part interested in the short-term interests of the workers and try to maximize the amount of salary and benefits which they can obtain at the expense of the shareholders. As members of the board of directors, the employee representatives are interested in the long-term best interests of the company. As these two principles may bring about a conflict of interest, employee representatives may not be trade union leaders.

¹⁷⁵ B. Nagel, "Erosion der Mitbestimmung und EG-Kommissionsentwürfe zur Europa-AG", 7 Arbeit und Recht 205-14 (1990).

¹⁷⁶ For an interesting discussion on the international competition for scarce capital see C.Y. Baldwin, "The Capital Factor: Competing for Capital in a Global Market", in M.E. Porter (ed.), Competition in Global Industries (Boston: Harvard Business School Press, 1986) pp. 185-223.

c. An Alternative Explication

For some commentators the theory of the firm works well in practice, but does it work in theory? The answer is no. While Gifford, Furubotn, and Hodgson and Jones,¹⁷⁷ may prefer to have firms which have certain characteristics, their preferred forms may not be appropriate when taking into account divergent national economic styles. As a result, the following interpretation of the relationship between the various stakeholders of the firm is quite different from those of the authors mentioned above. It is one which works both in practice and in theory.

As people and firms must somehow interrelate with each other, some kind of constitution must exist to regulate this interrelationship. From a Public Choice point of view, the following conclusions can be reached: (1) Governments share a common purpose in providing an efficient array of organizational forms in order to create a system where firms can organize in manners which promote economic efficiency and minimize transaction and agency costs; and (2) Company laws (a type of constitution) are enacted in the spirit of this societal balance. The national value system and economic style reflect the degree of trust and the amount of consultation needed to promote harmony in companies. Creditors', managers', shareholders', and employees' needs differ according to their level of trust and general temperament. Should this general level of trust and temperament differ, agency and transaction costs will be different. Therefore, countries should have different structures which clearly reflect these relationships. These relationships alone will determine whether co-determination or any other form is economically efficient. In this respect, economic analysis is better when it is descriptive as opposed to prescriptive.

While not discounting that there are some firm-specific investments which workers make, the type and the value of this investment will vary according to the national economic style under which this investment is undertaken. Perhaps more importantly, the degree of loyalty which employees are willing to provide to the firm and the firm is willing to provide to the employees is at least partially a function of national economic style. Each national economic style will be reflected in the relationships between groups in the firm which will result in different types and levels of cost in motivating employees to perform optimally; in order to perform optimally, there is little question that, because of differences in national economic styles, Israeli and Japanese employees need to be motivated and monitored in different manners.

The four examples of varying style characteristics found in different countries outlined above can serve to illustrate how different levels of contracting and agency costs will require different structures to elicit efficiency. As pointed out in the first example, France and the Netherlands will require different monitoring and decision-making structures to account for their tendency for centralized/decentralized decision-taking styles in order to elicit efficiency.

In the second example one could reason that the most important difference between Saudi Arabia and the United States is that in Saudi Arabia the relationship to the parties is often more important than the contract itself, while in the United States the contract itself is often more important than the parties.¹⁷⁸ As a result one could imagine that organizational structures and the nature of work might be much more informal in Saudi Arabia than in the United States.

In the third example, the length of the contracting period, particularly in the area of financing, will cast different risk and time projections on the company's management. As a result different types of contracting will be done and different types of monitoring will be required. Because of differences in time horizons in the area of financing one would expect German companies to be better able to engage in a diversified pool of risks through internal hedging and to be able to invest in projects with a longer pay-back period than in Great Britain. One

¹⁷⁷ G.M. Hodgson and D.C. Jones, "Codetermination: A Partial Review of Theory and Evidence", 3 *Annals of Public and Cooperative Economics* 329-340 (1989).

¹⁷⁸ The American affinity for written documents, stems back at least to the Revolutionary War period when Thomas Jefferson took exception to the whims of King George III by stating that the United States was "a nation of laws not of men."

should also not be surprised, due to the length and riskiness of the contract, to find that those providing the longer-term financing (usually, but not always banks) would require membership on the board of directors to advise on policy and to monitor risks.

In the final example, it was mentioned that Japanese workers' lives are organized around the firm and their co-workers. As firm-specific investments are high, fellow workers will exert enough peer pressure to lower monitoring costs. In Israel, workers were largely independent contractors who show up for work for their pay check. As loyalty is not mutual monitoring costs are higher.

Given these differences in national economic style, the quality of work done by civil servants with similar employment conditions might be higher in Japan than in Israel.¹⁷⁹ As Michael Porter points out, emulating another nation's model for national advantage may not be efficient. "The task for any government is to understand the principles of national advantage and translate them into policy initiatives that reflect the nation's particular circumstances. Good policies in one nation may well be bad policies in another."¹⁸⁰

One of the main purposes of Chapter 2 was to demonstrate that certain types of background laws may be efficient - but only in a particular context. If efficient background law is the aim of each country, one would expect that because of divergent national economic styles, each country should have its own company law. One should also expect that in order to obtain efficiency, different countries may enact different organizational forms.

This analysis will come as a surprise to many persons advocating various corporate structures for universal use. It calls into question the European Commission's attempt to mandate a certain organizational structure for European companies. This effort was initiated in the draft Fifth Directive on the Harmonization of Company Law,¹⁸¹ which was later the subject of a 1975 green paper¹⁸² and later revised in 1983¹⁸³ and amended in 1990.¹⁸⁴ The first two papers, based on the German system of codetermination, mandated a two-tier system of management with a board of supervisors and a board of directors. The board of directors were chosen by the board of supervisors. Two-thirds of the members of the board of supervisors were to be selected by the shareholders of the firm and the other one-third by the employees of the firm. The final two revisions abandon the requirement for a two-tier board, but retain the requirement that workers are represented in some type of formal structure.

One should note that the Commission's position on both the two-tier structure and worker representation are minority positions as fewer than half of the member states have provisions for either in their own national company laws. One should also note that none of the member states have changed their company laws to adopt the Commission's proposals on either the structure of the company or worker representation, and there is no immediate likelihood that any will. As noted above and in Chapter 2, countries have a strong motivation to adopt efficient background laws, particularly in an international market for investment. Given this set of circumstances, it is unlikely that the Commission's proposals for harmonization will promote efficiency.

¹⁷⁹ This point is made by M.E. Porter, *The Competitive Advantage of Nations* (London and Basingstoke: Macmillan Press, 1990) at 808, footnote 5.

¹⁸⁰ *Ibid* at 623-24.

¹⁸¹ OJ 1972 C 131/44.

¹⁸² Bull. EC 1975 Supplement 8/75.

¹⁸³ OJ C 240/2 9.9.1983.

¹⁸⁴ OJ C 7/4 11.1.91.

In principle many people analyzing codetermination (including Furubotn and others)¹⁸⁵ might prefer the system because they have noted that in Germany and Japan there are measurable advantages in terms of productivity by having paternalistic companies which have a long-term commitment to employees and where employees feel a commitment to the long-term success of the firm. These commitments are part of Germany and Japan's national economic style. As in most instances, these measurable benefits have costs. These costs are a limitation on perceived personal freedoms, opportunities, and personal expression. One would also expect to find less entrepreneurship as there is a certain amount of risk aversion which is inherent in a culture of conformity. Even within Japan and Germany, individual citizens will almost certainly value these principles differently. Tom Peters stated what is wrong with admiring the former West Germany's success with co-determination and trying to spread it to other European countries. "National differences don't translate easily into any 'best' or 'worst' strategies. There is no 'one best way' of doing business, practised by any one nation, and worth mindless copying by all."¹⁸⁶

One of the reason why codetermination is espoused, is that the expansion of the production possibility frontier occurs when workers maximize their firm-specific investments; deeper involvement in the firm will give a better incentive for workers to invest in firm-specific skills and to help monitor other employees. As has been demonstrated, different countries have different contracting and monitoring costs. These differences require different types of structures. Which structure will bring about the happy end of increased productivity at the lowest cost will almost certainly depend on the cost structures found within the national economic style.

As the examples above indicate, national differences in transaction and agency costs almost ensure that this is true. The national economic styles of Japan and Israel are so different that any type of externally mandated structure would be unlikely to work. An imported structure would almost certainly add to transaction or monitoring costs. What might be nice in an ideal world is unlikely to work in the real world. The cost of even trying might be excessive. Instead of dreaming, a better approach for these theoreticians would be to try to locate instances where monitoring costs or transaction costs could be lowered.

Alchian and Demsetz better address what should be done in countries like Israel. Alchian and Demsetz reckon that at the core of the problem of team production is measuring the productivity of individual workers in team efforts. They ask: "What forms of organizing team production will lower the cost of detecting 'performance.'" Their answer is market competition.¹⁸⁷ Market competition will force corporations and businesses to instill a spirit of loyalty.¹⁸⁸ If they are unable to do this, productivity and quality control will suffer. This problem is further addressed in Chapter 5.

Section 4: Conclusion

One must ask why various countries have different (efficient) solutions to problems they have in common and how each of these laws may be efficient in its own specific context. Various countries have at times enacted company laws, labour laws, tax laws and regulations which have inhibited or promoted particular organizational forms in particular sectors without regard to their efficiency.¹⁸⁹ This outcome is unfortunate. Efficient outcomes would have taken into account the country's (or region's) national economic style and built upon it.

¹⁸⁵ For further information on codetermination, see H.G. Nutzinger and J. Backhaus (eds.), Codetermination: A Discussion of Different Approaches (Berlin and New York: Springer, 1989).

¹⁸⁶ T. Peters, "The Boundaries of Business: Partners - The Rhetoric and Reality", 69 Harvard Business Review 97-99 (September-October 1991) at 99.

¹⁸⁷ A.A. Alchian and H. Demsetz, "Production, Information Costs, and Economic Organization", 62 American Economic Review 777-795 (1972) at 779-81.

¹⁸⁸ *Ibid.* at 791.

¹⁸⁹ H. Hansmann, "Ownership in the Firm", 4 Journal of Law, Economics & Organization 267-304 (1988).

Efficient law might demand different national or regional solutions. Each country has its own institutions which are based on its national character. These institutions evolve over a long period of time and result in a certain national balance. Company laws should be enacted in the spirit of this societal balance. Two important aspects of the national economic style are the degree of trust and the amount of consultation needed to promote harmony in companies. Creditors, managers, shareholders and employees' needs differ according to their level of trust and general temperament. International differences in these cultural factors could mean that agency and transaction costs will be different. It should therefore come as no surprise that different organizational institutions have been developed in order to address these varying costs. If these costs are different, different forms of institutions will be more efficient. This analysis not only explains why different countries have different organizational forms, but also why small firms need a different operational form than larger ones and why more than one organizational form or even set of forms is necessary.

This analysis can also go a long way toward describing the apparent failure of the European Commission's effort to harmonize European company law. There is the enigma that neither convergence of the economies of the member states through market forces nor harmonization through European Community Directives and Regulations will bring about a single set of organizational structures which will be used in the Community in the foreseeable future, despite the best efforts of the Commission. To the contrary, the Commission, by developing a European Company Law and the European Economic Interest Grouping, has increased the number of organizational forms available to European businesses. This is not to say that the Commission's efforts should be considered as either inadequate or as a failure, since the availability of additional forms, especially in the multinational context, may promote organizational efficiency.

It is apparent that, there will not be a single, all-encompassing European company law which is consistently applied in all the member states. The goal of certain integrationists is to create a single European company law.¹⁹⁰ Some claim that a single European company law and organizational form is necessary to promote "a level playing field." What the integrationists often fail to address is the question of whether their concept of a level playing field is economically efficient. An efficient law analysis notes that various countries have different ways of doing things and that one universal European company law could not be efficient. The case for the efficiency of harmonization requires a complete and convincing explanation of why the company laws of at least 11 countries are inefficient in their own context.¹⁹¹

Karl Gleichmann, who used to work in the company law area at the European Commission, keenly sums up the problems of trying to adapt alien organizational forms:

"Industrial relations are determined by deeply-rooted conceptions of the respective social roles of workers and management. They are therefore very different from one member state to another. They have evolved over many years. To attempt to change them by decree from above is hardly likely to succeed. The systems can be made to converge, but must be allowed time. Mentalities - highly subjective attitudes of mind - play a major part in them. Certainly, such processes can be encouraged and nurtured. But problems are likely with attempts to transplant the fruits of one country's experience into other countries with a different background. Therefore, the proposal in the 1972 draft for a Fifth Directive was probably fundamentally flawed and politically unrealistic. It attempted to 'export' a system of employee participation

¹⁹⁰ The Commission's harmonization approach is based upon the Treaty of Rome articles 52 *et seq.*, which establish a "freedom of establishment." Those who argue for complete harmonization base their argument of their interpretation of the wording of Article 54(3)(g) which states that the Community should: "coordinat[e] safeguards ... for the protection of the interests of members and others [which are] required by Member States or companies or firms ... with a view to making such safeguards equivalent throughout the Community."

¹⁹¹ More than a uniform company law is necessary to achieve a totally level playing field. A totally level playing field would also require either adapting a common law system in which rulings of the European Court were binding on national courts, or alternatively removing all company law matters from the jurisdiction of national courts to a European court.

that had evolved over 50 years (employee representation on a lower-tier supervisory board had existed in Germany since 1922). It ignored the fact that one of the main conditions for employee participation in decision-making - consensus - was lacking. To try to impose it on them against their will was as unrealistic as it was futile. How sensitive this area is, is clear from the attempt to introduce legislation to promote closer industrial relations in France in 1986.¹⁹² This example shows how far apart even the Continental Member States are on this issue. Even for countries that do have a basic consensus between management and labour in industry, like the Netherlands and Germany, it is hard to imagine an exchange of their systems. In the past it has been difficult enough to gain recognition of the equivalence of the systems.¹⁹³

Perhaps De Alessi and Staaf best sum up the dilemma facing the European Economic Community as it decides whether to pass a uniform set of European company laws and, one hopes, considers the relationship between efficiency and national economic styles, when they wrote that: "Efficiency may be defined as the solution to a constrained maximization problem. Thus, given a set of institutions, the resulting solution of the economic problem is efficient. Institutions with different legal structures typically yield different efficient solutions, and which institution is adopted depends on the rules for choosing institutions. Economics is a powerful tool for analyzing the consequences of alternative institutions and, given an understanding of the effective constraints, for explaining (predicting) the evolution and adaption of competing institutions. Which institutions ought to be adopted, and whether or not they are more efficient in some sense, ultimately is a normative issue, and economics cannot provide the answer."¹⁹⁴

¹⁹² Ordonnance du 21.10.1986 No 86.1134 relative à l'intéressement et à la participation des salariés aux résultats de l'entreprise et à l'actionnariat des salariés, Revue des Sociétés 1986, p. 644.

¹⁹³ K. Gleichmann, "Perspectives on European Company Law", Forum Internationale (October 1989) pp. 8-9.

¹⁹⁴ L. De Alessi and R.J. Staaf, "Property Rights and Choice", in N. Mercuro (ed.), Law and Economics (Boston: Kluwer 1989) at 184.

***Chapter 5: The Brave New
World of Intergovernmental
Competition:
Efficiency in an International
Setting***

Abstract

After setting out the conditions for legal efficiency in a domestic setting in the first four chapters of this book, this chapter asks why domestic efficiency in a closed national market is not the same thing as efficiency in an international setting. Moreover, what was efficient ten years ago in an international setting has been almost revolutionized with the advent and diffusion of the microchip, fibre optic cable, satellite communication, the fax machine and better and cheaper international transport and communications. This chapter puts the changes of the last few years in an historical setting; discusses why the world is changing and the role of technology in the change; updates Coase's theory of the firm in the light of these changes; and concludes by discussing what implications the changing nature of the firm has for firms governments and the law.

Chapter 5: The Brave New World of Inter-governmental Competition: Efficiency in an International Setting

"We are living through a transformation that will rearrange the politics and economics of the coming century. There will be no *national* products or technologies, no national corporations, no national industries. There will no longer be national economies, at least as we have come to understand that concept. All that will remain rooted within national borders are the people who comprise a nation. Each nation's primary asset will be its citizens' skills and insights. Each nation's primary political task will be to cope with the centrifugal forces of the global economy which tear at the ties binding its citizens together - bestowing ever greater wealth on the most skilled and insightful, while consigning the less skilled to a declining standard of living. As borders become ever more meaningless in economic terms, those citizens best positioned to thrive in the world market are tempted to slip the bonds of national allegiance, and by so doing disengage themselves from their less favored fellows."¹⁹⁵

The purpose of the first four chapters of this book was to examine what was efficient law and efficient government policy in a domestic setting. International competition in general, and intergovernmental competition for investment and taxes in particular, changes the efficiency equation to at least some degree. This concept was initially illustrated in Chapter 2 when the reason why trade barriers, small stores and higher prices might be efficient for Japan was explained. Borders, however, have become of decreasing importance in economic terms. As a result, as the same example illustrated, international intergovernmental competition will almost necessarily lead to a decrease in the degree to which governments can become involved in and protect markets. As a result, efficiency will take less notice of maximizing aggregate satisfaction and take maximizing physical output into greater consideration. The first part of this book was about domestic efficiency in the context of the national economic style. The second part is about how international competition and technological changes have affected national governments.

In Chapter 1, the case for a different standard of efficiency - maximizing aggregate national satisfaction - was made. There are serious drawbacks to this approach in an internationally competitive economy, because governments face both a supply and demand constraint. "The major difference between government and the private firm is that, in the case of government, the relevant demand for government is the willingness and ability of residents to live and earn their incomes (from which governments extract tax revenues) in a given jurisdiction."¹⁹⁶ High taxes and intense regulation tend to push capital and people outside the jurisdiction. Social security, unemployment compensation and the availability of retirement income all create disincentives to work. The effect of these programmes on government coffers are larger than many people assume: not only do people receive benefits from the system - they also no longer contribute to the programme's financing. Moreover, the average recipient receives an amount many times what he would contribute if he were paying in and every new recipient puts an even greater pressure on those who continue to pay in.

The measurement of inputs as described in Chapter 1 remains unchanged. The purpose of Chapters 3 and 4 was to point out that national economic styles will necessitate different laws (considered to be inputs) to maximize both satisfaction and output. In the international equation, the measurement of output changes from attempting to maximize aggregate satisfaction to maximizing physical output. The purpose of this chapter is to indicate what pressures history and technology are placing on the national efficiency equation. Chapter 6 will point out why governments are under increased pressure to supply efficient regulatory climates in the form of background laws (Chapter 2) in general and company laws in particular. Chapter 7 will analyze the reasons why governments are under increased pressure to provide hospitable tax climates.

¹⁹⁵ R.B. Reich, *The Work of Nations* (New York: Alfred A. Knopf, 1991) p. 3.

¹⁹⁶ R.B. McKenzie and D.R. Lee, *Quicksilver Capital* (New York: The Free Press, 1991) at 89.

Section 1: Introduction

As described in Chapter 1, markets are based on a set of legal norms. An efficient market will be based on a system of efficient laws. If national economic styles are radically different, two radically different sets of market conditions for the same product or service can be simultaneously efficient. In most cases, it can be argued that, for markets in differing countries to be efficient, laws should and must be different.

As described in Chapter 4, markets can only be efficient if the legal norms which regulate the market properly reflect the national economic style. Markets are efficient when the combination and interaction of national interests, tastes, values, preferences, institutions and policies are properly taken into account and reflected by the market conditions. Only under this condition can markets be developed which maximize societal satisfaction in particular countries.

How the markets themselves operate will have a profound effect on the creation of a national economic style. For example, an efficient solution for a country which favoured relative income equality might be to have high and progressive personal and social security contributions, high minimum wage levels, an extensive social security system and a national health service. In economics, just as Sir Isaac Newton predicted for physics, for every action there is an equal and opposite reaction. Such income difference neutralizing policies will have other perhaps unintended consequences, such as reducing the incentive both to employ workers and to work. First, on the supply side, higher taxes will reduce the marginal incentive to work (at the very least the number of hours which workers are willing to work). Second, on the demand side, higher than market wage levels (which include employer contributions to health care and social security) will reduce the marginal incentive to employ workers and lead to unemployment.

The resulting unemployment and tax burden might provoke another response: resentment. This resentment will encourage current tax-paying citizen either to work outside of the tax system or to emigrate to places where their efforts are better compensated, on an after tax basis. High taxes, uncompetitive regulation and uncompetitive high wage levels, will send investment capital scampering across borders to other countries at the speed of light at the mere push of a button. While money today can be moved at the speed of light through fibre optic cables, physical plant and equipment cannot. The flows of capital which are transferred are enormous: in the range of 30 to 50 times that of world trade.¹⁹⁷ Since investment usually follows monetary flows, one way to measure the competitiveness of an economy is to measure how much capital is flowing in versus how much is going out. If money is fleeing, longer term prospects for the economy are weak, if money is coming in the outlook is strong. This is true because there is a direct relationship between investment and future productivity, and increased productivity leads to affluence. An efficient response to capital outflow might be to cut back on at least some of the previously enacted measures which were formerly efficient, but no longer are. In this regard, national economic styles will necessarily change over time. Pressures on governments to change their ways can be put in a historical perspective.

Section 2: Historical Perspective

History repeats itself. The relative balance of power has shifted throughout history from the people to the sovereign and back again. From the earliest days of man when people first banded together to give a larger share of decision-making to a smaller group of decision-takers, shifts of power have gone back and forth between the sovereign and the ruled. When the power of the sovereign became too great and self-serving, people have always revolted. When there was a perception of insufficient administration, governments became more powerful. Shifts in the relative balance have seemed to come in certain waves.

The Reformation came in reaction to the strong, centralized Catholic Church of the Sixteenth Century. The parallel iron-fisted and often corrupt rule of national governments lasted into the Seventeenth and Eighteenth Centuries when revolts and civil wars loosened government control. This period of overly strong government rule provoked the writings of what are still considered the greatest political thinkers since the ancient Greeks: Burke,

¹⁹⁷ W.B. Wriston, "On Track with the Deficit", *Wall Street Journal* (January 6, 1989) p. A10.

Humboldt, Voltaire, Hume, Locke, Smith, Madison, Jefferson and Mill. This new era corresponded with the industrial revolution. Mercantilism and *laissez faire* became the cry of the new era.¹⁹⁸ A new elite was formed: the industrialists. When the pendulum arguably swung too far in this direction there was another reaction in the form of condemnation from such diverse sources as Karl Marx, Emile Zola, Sinclair Lewis, Charles Dickens, Thomas Carlyle¹⁹⁹ and Teddy Roosevelt. A reaction to the perceived insufficient administration led to, among other things, the evolution of the trade union movement. The socialist-based trade union movement was the forerunner of the development of social welfare systems beginning in the late Nineteenth Century, and of communism in the Twentieth Century.

A cradle-to-grave social welfare system of course has to be paid for. This fiscal reality resulted not only in direct taxation and transfer payments to the people, but also to increased regulation. At least some of this regulation has been created to shift the cost of some national social welfare measures to business.²⁰⁰ Regulation also has a measurable cost.

The state, in at least some countries, took a role which was too utopian and overly interventionist. There were good reasons for this. After the depression of the 1930s, there was the triumph of Keynesian interventionism; in the aftermath of World War II, there was the triumph of the Marshall Plan. Both strengthened public faith in the visible hand of government to the extent that even the World Bank and the United States urged Third World governments to draw up five-year plans.²⁰¹ A belief in the power of government to solve economic problems led to economic nationalism becoming the order of the day, not only in communist countries, but also in those of Latin America, Africa and Asia.

The response in the Western democracies was to form various social security systems based on a pyramid scheme. As with all pyramid schemes, one initially starts with a large number of contributors and a small number of takers. As more people become takers, the base of the pyramid has to grow or the base of the pyramid will not be large enough to support the structure. After the depression of the 1930s, and especially after World War II, Western economies grew at almost historically unprecedented rates. People were having babies. It seemed as if prosperity would never end. In the 1960s and 1970s, however, two dramatic events occurred which shrunk the base of these pyramids. First, effective and reliable forms of birth control had a dramatic effect on birth rates. Second, economic growth began to level off especially with the two worldwide oil shocks. As a result the pyramids could not be sustained, as many of the assumptions upon which they were formed did not come to pass.

Once the bubble began to burst, blame began to be allocated. In the most highly taxed and highly regulated Western economies the excess was referred to as a type of sickness, which in Europe was called "Eurosclerosis."²⁰² The over-extension of government gave prominence to a new group of both economic and political thinkers: Buchanan, Hayek, Friedman, Mises, Simons and Röpke. The reaction to over-extension

¹⁹⁸ For an excellent overview of this period see F. Braudel, Civilization and Capitalism, 15th-18th Centuries (New York: Harper and Row, 1984).

¹⁹⁹ Today Carlyle is mostly remembered for calling economics "the dismal science." Carlyle, however was an idol of Joseph Schumpeter. Schumpeter described Carlyle in almost epic-like prose: "For economists he is one of the most important and most characteristic figures in the cultural panorama of the epoch - standing in heroic pose, hurling scorn at the materialistic littleness of his age, cracking a whip with which to flay, among other things, our Dismal Science." J.A. Schumpeter, History of Economic Analysis (1914) Reprint (Oxford: Oxford University Press, 1954) pp. 409-10.

²⁰⁰ E.g., legislation which requires business to provide health insurance to both employees and their families; mandatory pension funds; unemployment insurance; and regulation of paid holidays.

²⁰¹ B. Jalan, India's Economic Crisis: The Way Ahead (Oxford: Oxford University Press, 1991) at 8-11.

²⁰² For a good overview of some of the causes of Eurosclerosis see P.R. Krugman, "Slow Growth in Europe: Conceptual Issues", in R.Z. Lawrence and C.L. Schultze (eds.), Barriers to European Growth (Washington: The Brookings Institution, 1987).

can be seen in Western countries in an almost universal fall in personal and corporate tax rates and increasing tax revolts.²⁰³ Excessive regulation and its cost led to the European Community member states' adoption of the Single European Act, something that was unthinkable only a few years earlier.²⁰⁴ The reaction in the rest of the world led to something even more astonishing: the dramatic overthrow of communism, the opening up of formerly closed economies and the emergence of democratization. The reason why this has happened will be outlined in the following section.

Section 3: Why the World is Changing

Dramatic changes in national economic styles were apparent in the 1980s. Until the 1980s the watchwords of the government were embedded in the words "state action" and "regulation." The invention of the microchip and the invention and diffusion of the personal computer and fibre optic cable changed how knowledge and information is disseminated and transmitted. This coincided with the almost revolutionary political leadership of Ronald Reagan, Margaret Thatcher and Mikhail Gorbachev. These leaders all questioned whether the role of the state needed to be so large. They all took measures to stop and in some cases reduce the growth of government. They all attempted to shift at least some of the burden for which the government was formerly responsible back to individuals. While their policies had varying and debatable degrees of success, the political position which they articulated struck a cord with a large number of people throughout the world: individuals, not government, should have more control over daily life and decision-making. A new revolutionary war was happening. The war was fought with a minimum of bloodshed. History was repeating itself - but the revolution was fought with ideas, not bullets.

Other events occurred during the 1980s: Japan became the world's largest creditor; worldwide trade exploded; a worldwide debt crisis hit; the Berlin Wall fell. The internal fall of the Soviet Empire occurred soon after in 1991. In 1985, the European Community adopted the White Paper which called for a Single European Market by 1992 which required breaking down national barriers.²⁰⁵ Arguably, the strategy for the Single Market was a mere catching up exercise: breaking down technical and physical borders, cutting red-tape, codifying and putting into law rules that European businessmen need to conduct their increasingly cross-border activities. A single European currency seems to be a short step in this process.

The new worldwide catchwords became deregulation (except where the environment is concerned) and privatization. Together these events have changed the context of the debate regarding efficiency, which in turn in some respects has influenced the national economic styles of many countries.

In the context of international competition: "Government leaders have increasingly had to think more like executives caught up in competition for consumer's dollars. They have had to think more in terms of cutting the 'prices' - that is, the taxes and regulatory costs - they charge their citizens and in terms of providing greater value for the tax dollars they collect. More and more, they have had to respond to the demands of political interests groups for special privileges and protection with the lament that the government's fiscal and regulatory hands are tied and that it must keep the nation's policies competitive with those of other countries."²⁰⁶

Chapters 1 and 2 pointed out that governments have extensive powers to tax, make laws and regulate. The only constraint mentioned was the constitution. This lack of constraint is of course only relative - both in domestic

²⁰³ See generally J.A. Pechman (ed.), World Tax Reform: A Progress Report (Washington: Brookings Institution Press, 1988).

²⁰⁴ This process should be seen in the same terms as the fall of communism. The Single European Act allowed national economies to deregulate and expand, as opposed to keeping the status quo and preventing growth. Supra note 2 at 64.

²⁰⁵ Completing the Internal Market (Com(85) 310).

²⁰⁶ Supra note 2 at 12.

and international terms. But government policies which might be efficient in the sense described in Chapter 1, cannot necessarily be maintained in an internationally competitive environment. Even if high taxes, high regulation and high government control leads to maximum aggregate satisfaction, the persons and firms that do not like this set of policies may move themselves and their capital to jurisdictions which are less encompassing, especially if they have to pay for inefficient policies. If enough people move, disinvest or simply do not reinvest their profits in the jurisdiction, in the long term the burden becomes greater on those who elect to remain. This increased burden will make the marginal burden higher and governments progressively weaker. As Norman Macrae wrote: "Areas which vote to have high taxes will be residually inhabited mainly by dummies: people who vote to have tax money spent on themselves, without actually earning enough money to be taxed."²⁰⁷

The emigration of highly skilled workers in reaction to high taxes is not mere conjecture. The "brain drain" from egalitarian Europe to less egalitarian America offers at least some evidence for this phenomena.²⁰⁸ Obviously the loss of these highly educated, highly skilled and high income individuals has added to the tax burden of the remaining individuals and firms.

Modern technology has already eroded governments' ability to work in a vacuum without regard to what other countries around the globe are doing. Since information and money can circulate around the globe through satellites and fibre optic cables literally at the speed of light, the ability of governments to keep money inside their borders and information out of the country has been almost entirely eroded. The days which border guards could be used to perform these duties is over. In the final years of the Berlin Wall, the wall itself was more psychologically symbolic than real. West German radio and television kept East German citizens apprised of ideas, policies, freedom, wealth and possibilities. In retrospect, one should not be very surprised that the corrupt East German state fell so quickly: it was evident that most East German citizens had nothing but contempt for their state. Given the advances in technology, it is almost inconceivable that the benefit of effectively sealing off borders would be greater than the cost. As a result the importance of national borders has decreased dramatically.

Over-regulation and taxation eventually lead to a good deal of movement or disinvestment. Except by competing with other governments, governments have little power to stop it. Over the past few years, we have seen the plight of large numbers of unwanted refugees attempting to move to more liberal jurisdictions. Along border areas many people are living in low tax jurisdictions while working in higher tax jurisdictions. Third World countries, Germany²⁰⁹ and Sweden²¹⁰ have seen large amounts of money, owned by their nationals, flow to places where the propensity to make profits is greater and taxation is lower. The focus of the remainder of this chapter is on why governments are losing their ability to do what they would like, and what effect domestic policies have on a country's international position.

²⁰⁷ N. Macrae, "The Next Ages of Man", *Economist Survey* (December 24, 1988) at 8-10.

²⁰⁸ V.B. Agarwal and D.R. Winkler, "Migration of Professional Manpower to the United States", 50 *Southern Economic Journal* 814-30 (1984); and W. Huang, "A Pooled Cross-Section and Time Series Study of Professional Indirect Immigration to the United States", 54 *Southern Economic Journal* 95-109 (1987).

²⁰⁹ German businesses invested DM 30bn outside of Germany in 1990, while non-German businesses invested only DM 3bn in western Germany according to a report from the IDW economic institute in Cologne. D. Goodhart, "Germans Concerned at Poor Foreign Investment", *Financial Times* (August 17, 1991) p. 2.

²¹⁰ Swedish investors are engaging in more and more direct foreign investment. In 1989, Swedes invested six times as much in new investment outside of Sweden than inside Sweden. P. Woodall, "The Swedish Economy", *Economist Survey* (March 3, 1990) at 21.

Section 4: The Role of Technology

In an important and enlightening new book, *Quicksilver Capital*, Richard McKenzie and Dwight Lee eloquently argue that technology is changing governments' ability to make inefficient policy decisions.

"Until recently, the prospects that people might move their capital or themselves in response to taxes did not have to be given much thought by political leaders, simply because people could not move except at great expense. People and capital were largely captive of the political decisions made with great deliberation in the halls of the world's legislatures or parliaments. The politics of tax decisions had to be considered carefully, but the economics of tax decisions could be ignored. Today, technology permits people and their capital to be far more fugitive, far more capable of bounding over government borders - far more like quicksilver - slippery, elusive, and hard to contain and control. As never before, political leaders must be concerned that their efforts to raise tax rates in their own jurisdictions will mean that other leaders in adjoining or even far-flung governments, who have not touched their rates, will enjoy revenue increases....The evidence continues to mount that people, capital, jobs, and incomes gravitate toward government jurisdictions with the most favorable fiscal and regulatory environments. Much has been written and said about the 'competitiveness' of business....[but] little has been made about the 'competitiveness' of governments....This growth in business competitiveness has necessarily forced governments into a competitive struggle for the world's human and physical capital base....World governments have had to compete against one another by seeking more efficient policies in order to lure and retain the physical and human capital that is now so crucial to modern production processes and to the tax bases on which governments depend."²¹¹

McKenzie and Lee illustrate that there are three factors in analyzing the role of technology: what technology can do, its diffusion and the cost of using what has been developed.

a. Technological Capabilities, Cost and Diffusion

We truly live in the information age. Technological improvements have led to faster travel and communications at a fraction of the cost of yesteryear. This has dramatically reduced the size of the world. While it has long been said that "it is a small world" - at least since the time when Stanley ran in to Livingstone - the practical truth of this must be considered by measuring both the time that it takes to travel and communicate and the cost.

b. Telephones

Over the last 30 years, the ability to communicate quickly and efficiently has almost gone beyond the science fiction promulgated less than 25 years earlier. While the telephone was invented in 1877, until relatively recently it has been far too expensive to be used in poorer countries and over longer distances. As a result, international telephone calls were relatively rare. Technological advances have made it cheaper and cheaper to call greater and greater distances. The drop in costs differs significantly from country to country depending on how much international calls are "taxed" by the state-run monopolies who still control most telephone companies. Increased privatization and competition through the break-up of monopoly statuses should in the future make international calls much cheaper in many countries.²¹² Modern technology has made the cost of switching an international

²¹¹ Supra note 2 at x-xi.

²¹² In order to overcome state telecommunications monopolies, an increasing number of multinational firms have built their own telephone networks. In 1991, \$2.8 billion was spent renting lines and running private telecommunications networks. This amount has been rising at a rate of 20 percent per year. This figure may increase, since foreign direct investment has been growing at a rate of 30 percent per year. One of the reasons is that international telephone calls are the most profitable part of telephone companies. In Great Britain, which has a minimal amount of competitive competition and by no means

directly dialled call to about 3 American cents; this is not significantly more than the cost of a local domestic telephone call.

The increase in the number of international telephone calls is nothing short of staggering. In 1960, 3.3 million international telephone calls were made; by 1970 the number increased seven-fold to 23.4 million; in 1980 199.6 million calls were made; and in 1986 the number rose to 478 million. Throughout the 1980s the number of international telephone circuits continued to increase by 40 percent each year and the transmission capacity of Trans-Atlantic fibre-optic cable doubled every year. Line charges are expected to drop by 22 to 40 percent by 1996.²¹³

c. Telecommunication

The telephone line is no longer limited to the transmission of voice communication. The telephone jack has become an outlet to the world of images, computers and fax machines: through a telephone line one can speak or send television images, pictures or data in the form of numbers, graphs or words. As a result people no longer need to be in close proximity in order to conduct business. Throughout much of the Western world and even in third world capitals, telecommunication allows one to almost instantaneously communicate with someone on the other side of the globe. About the only thing that one as yet cannot do is to shake hands. And if one does have to conduct business in person, one can now go virtually anywhere in the world from any other point in 24 hours or less at a greatly decreased cost.²¹⁴

d. Computing Power

Telephone lines are increasingly connected to computers and computer data bases as the cost of doing so becomes increasingly cheaper. Between 1960 and 1990 the price of computing power in America shrank in real terms by a factor of 6,000. This drop of 25 to 30 percent per year is still continuing. Even though the world has witnessed a dramatic drop in the price of computing equipment, the amount spent on computers has shot up dramatically. In 1970, information processing equipment amounts to 11 percent of all American non-farm durable equipment investment; by 1989 the figure was 51 percent. This figure does not include individual expenditures on personal computers. This obviously shows that the amount of computing power which came to the market increased exponentially.²¹⁵

e. Travel

The increased speed of transport and a drastic reduction in the cost of international travel has greatly added to man's ability to communicate long distances. The average speed of air travel increased from 149 miles (238.4 kilometres) per hour in 1944 to 493 miles (788.8 kilometres) per hour in 1986. In 1937, the cost of an airplane ticket from Los Angeles to Tokyo was \$12,725 (measured in 1986 dollars). By 1973 the cost of a flight of a similar distance was down to \$1,860. By 1985 the cost had dropped another 50 percent to \$930. Between 1937 and 1984, the price of a transatlantic flight fell from more than 300 percent to less than 8 percent of American annual per capita disposable income. This dramatic decrease in price has led to greatly increased international

has the highest international rates in either Europe or the rest of the world, international calls account for 5% of the traffic, yet provide 30% of the profits. "Telecoms: Trail Blazer", The Economist (September 21, 1991) pp. 82-83.

²¹³ Supra note 2 at 47-48 and 73.

²¹⁴ This has led to a great increase in demand for telephone lines. During 1990 and 1991 alone, the author has been confronted with new dialling codes in the United States, the United Kingdom, the Netherlands and France for city or area codes which he used to dial with different and often shorter dialling codes.

²¹⁵ "Too Many Computers Spoil the Broth", The Economist (August 24, 1991) p. 30.

air travel. From a negligible base in the 1930s, international travel took off to 27.6 billion passenger miles in 1970 and more than doubled to 64.4 billion passenger miles in 1986. These trends are continuing.²¹⁶

f. Electronic Immigration

As a result of these changes the world is indeed becoming smaller. Computers and telecommunications facilities allow instantaneous links which easily cross borders. The cost of this communication is so low and is so easy to accomplish that an increasing number of American firms are doing jobs ranging from simple data entry to accounting, credit card processing, medical and insurance transcription, telemarketing, and technological support for products over toll-free numbers to English-speaking countries with lower wage levels. The countries which are primarily benefiting from this technological breakthrough are Barbados, Jamaica, the Philippines, Singapore and Ireland. One of the advantages for American companies who use Ireland, the Philippines and Singapore is that, because of the different time zones, they use the mainframe computer located in the United States at off-peak hours when the computer tends to be under-utilized.²¹⁷ The workers who benefit from this technology have been called "electronic immigrants" to the United States.²¹⁸

Section 5: The Theory of the Firm Updated

This change in technology has had a dramatic effect on how the world operates. In addition to having extraordinary ramifications for governments, technology has also had a marked effect on firms.

As indicated in Chapter 2, in a seminal article, "The Nature of the Firm," Ronald Coase argued that firms exist to reduce transaction costs. Since gathering information, contracting and monitoring can be expensive, a firm may be able to achieve economies of scale in these areas. To the extent that firms are able to do this at lower costs than individuals they will be efficient and cost effective. In the firm, the time-consuming bargaining process can be minimized through the development of hierarchical structures and skill specialization²¹⁹ and by issuing orders to the economic actors through a series of commands. The hierarchical structure and the commands reduce transaction costs.²²⁰

We saw that firms are based on a series of "nexus" of contracts. These contracts require some further elaboration at this point. There are four basic steps toward forming an enforceable contract. The first is gathering information to determine what is needed and what must be contracted for. Second, one must find someone to contract with. Third, a contract must be negotiated and formed. Finally, the contract must be monitored to determine whether the terms of the contract have been adhered to.

Since the article was published in 1937, technology (especially since the development and increasingly widespread diffusion of the microchip) has made many changes to economic life. In *Quicksilver Capital*, McKenzie and Lee point out that information costs and bargaining costs have been lowered with the advent of the microchip and modern telecommunications. An increasing number of jobs have to do with processing and creating information; fewer involve working with one's hands. One can infer from this discussion that there is a

²¹⁶ Supra note 2 at 73.

²¹⁷ B. Wysocki, Jr., "Overseas Calling: American Firms Send Office Work Abroad to Use Cheap Labor", *Wall Street Journal Europe* (August 23, 1991) p. 1. The article notes that electronic scanning of printed material will supplant many of these jobs in the near future.

²¹⁸ Supra note 2 at 232.

²¹⁹ A.A. Alchian calls specialization "asset-specificity" in "Specificity, Specialization and Coalition", 140 *Journal of Economic Theory and Institutions* 34-39 (1978).

²²⁰ R.H. Coase, "The Nature of the Firm", 4 *Economica* 386-412 (1937). Reprinted in R.H. Coase, *The Firm, the Market and the Law* (Chicago and London: University of Chicago Press, 1988).

worldwide change in the costs and the nature of the four above mentioned contract steps. This will be more extensively discussed below. But in order to understand the context, it is important to discuss what has happened over the past few decades.

Cost of Gathering Information

Information has gone from being something that was relatively difficult to obtain and to collate, to something that is relatively easy to obtain. It has reached the point that some managers now feel they get too much information.²²¹ In 1991, European offices produced 3.5 billion sheets of file paper every day. This amounts to 45 sheets for each office worker. This figure does not include a daily output of 800 million sheets of computer printouts, 300 million photocopies or the 100 million letters written and sent out. These figures make a mockery of the concept of the paperless office.²²²

Data which used to have to be published now goes directly to a data base which can be accessed immediately. Raw data can be manipulated in quick order for virtually any purpose.²²³ Through computer modems, one can reach data bases which exist throughout the world. If information can not be obtained in this manner, one can almost universally (at least in countries with a modern telephone system) directly dial almost every telephone in the world, without the necessity of going through an operator. In order to find out who to telephone, one can access an almost mind-boggling number of guides or lists of people to contact for almost any purpose. If the information cannot be found through modems, information can be obtained through the use of a telephone (voice transmission), telex, fax, overnight mail, regular post, satellite or courier.

Another technological advance has led to the development of low cost desktop publishing over the last decade. As a result, the number of magazines, newsletters and specialist trade publications has skyrocketed and reams of general and specialist information can be found quickly at relatively low cost. The wide scale availability of this information means that there is less need for in-house researchers and a greater need for journalists.²²⁴

²²¹ The complaint of one manager is enlightening. "Someone asks if I can give them the name of the winning horses at next week's races, and I say 'yes' of course. Give me the names of all of the starters.' I will give back a pile of paper as high as the Eiffel Tower, which will include the winning combination but will be worth nothing because nobody will be able to find it. What he wants is the winning combination, which is not a piece of information but a tip. Like that tip, most essential business information can usually be expressed in very few words and cannot be stored in a data base." B. James, "Turn Off the Computer and Give Me the Facts", *International Herald Tribune* (September 19, 1991) pp. 11-12 at 11; also see J.S. Hirsch, "Managers Seek to Bail Out From Flood of Information", *The Wall Street Journal Europe* (August 20, 1991) p. 9.

²²² D. Bradshaw, "Office Technologies: Need for an Overall Plan", *Financial Times* (October 8, 1991) p. III/1.

²²³ As Will Rodgers, a famous American wit of the first third of the twentieth century said: "There are lies; there are damn lies; and there are statistics."

²²⁴ The economics of this shift in employment is interesting. First, assuming similar work is both required and realized, economies of scale can be reached since there is less duplication of effort and the cost of subscribing to a specialist information service will almost certainly be less than hiring researchers in-house. Second, there is less risk involved. In-house researchers take vacations, may not be properly motivated or instructed, get ill, or may not be competent. Since service can easily be cancelled at virtually no cost, it is less likely that quality service will be interrupted if one uses specialist publications. Finally, if there is competition for providing information, should quality or service suffer, one's "research staff" can be changed without training costs. If the supply of a certain type of information is valuable, one would expect that various publications or subscriber services would be formed to compete with each other to provide information and analysis. This competition for profits and market share might well improve market information since the cost of doing inferior work will be reflected in a loss of customers.

Another consequence of desktop publishing and an increased number of specialist publications, is that businesses (junk mailers) have the ability to target their advertising to specific customers on a worldwide basis.

The Cost of Finding Contracting Partners

This same information-gathering process can be used to find contracting partners. When information was more difficult and costly to obtain, businesses and individuals were limited to a relatively restricted geographical area. As a result markets tended to be more local or regional.

As the cost of communication drops, it becomes increasingly feasible to get price quotes and do business with firms from around the globe. One can telephone or fax virtually every business in the world to see whether they are willing or able to supply any type of good or service. The decreasing cost in both time and money to travel around the world makes it more and more advantageous to do so.

This change in the cost structure has increasingly led to the search for business partners over a larger and larger sphere. The cost of a European finding a business partner in Asia would have been almost prohibitive for most transactions: only the very largest ones could be justified. Today, if one can figure out the difference in time (due to the various time zones), he thinks little of calling someone in Asia. If the initial telephone call or fax proves to be promising, one thinks little of hopping on an airplane to gather more information. Technology has dramatically decreased the difference in the marginal cost of gathering information regarding a potential supplier or customer: whether the client is 500 kilometres away or 5,000 kilometres away the difference in the time²²⁵ and the cost of a business trip is relatively small. As a result, the likelihood of doing business with firms further away increase.

The Cost of Negotiating a Contract

Of the three stages of contracting, it is the negotiation stage for which it is most difficult to determine whether costs have fallen or risen. Costing is difficult because in at least some respects, business relationships are more complex than ever. While recognizing that to a certain extent contracts have become more complicated, one can also look at some factors which have made it easier to negotiate and form a binding contract. In this area there have been many technological advances which have permitted negotiations to be carried out less expensively. The degree of the cost reduction varies but in at least some cases the savings can be large.

The first and foremost reason for a reduction in negotiation costs lies in the increasing acceptance of the English language as the worldwide business language. While the knowledge and use of English in business transactions is not universal, especially in Central Europe where German and Russian are the *lingua francas*, there is little doubt that there has been a worldwide trend toward the use of the English language, especially in multinational companies. The increased use of English allows persons of different native tongues to negotiate a contract without interpreters. Contracts can either be negotiated over the telephone or in person at lower cost. Drafts of contracts can be sent by fax or modem in quick order at low cost; or alternatively, one can travel in person more quickly and inexpensively.

The ease in physically writing out contracts has increased with the use of word processors. Word processing provides two cost reduction factors. First, one can easily adopt a clause or an entire contract from a contract which has already been drafted (this involves the use of all or part of the standard form contract discussed in Chapter 2). Secondly, through word processing a single word, letter or punctuation mark can be changed and "re-typed" in an instant at virtually no additional cost. Before word processing any changes required a totally new contract to be typed. If mistakes were made in typing, the typist often had to start typing the page with the mistake again.

²²⁵ While the time in the air makes some difference, when one factors in the travel time to and from the airport and the ability to work with notebook computers on the airplane, the extra working time lost making a longer trip is marginal.

Finally, the emergence of 'quicksilver capital' allows for easier transfers of funds. Instead of relying on banks to provide letters of credits, firms can increasingly transfer funds across borders without needing to use banks to arrange and facilitate transfers. Escrow funds can be set-up through the use of faxes and telexes. A prompt, low-cost payment system facilitates trade.

The Cost of Monitoring

The cost of monitoring has increased dramatically since Coase wrote on the theory of the firm. This is tied to the changing nature of work. In the 1950s, 70 percent of workers in Western Europe and the United States used their hands at work. Now 70 percent of these workers use their brains.²²⁶ This percentage is increasing. Nine-tenths of all new jobs created during the 1980s in America "went not to hamburger flippers but to white-collar workers."²²⁷ As brain power becomes a larger and larger element of work, as witnessed by both the growth of the service sector and the changing nature of the work which people do, to monitor large numbers of people has become increasingly difficult.

While one can easily monitor the physical output and quality of work of factory workers, it is more difficult to monitor service workers. The monitoring of brainwork is subject to various interpretations as to both output and quality. It is simple, for example, to monitor workers in a light bulb factory by physically counting output per man-hour, and by random sampling for quality. To measure productivity, one can count the number of light bulbs produced and easily compare the number which were produced today and compare the number with yesterday or last year with the same number of workers. Measuring the relative quality of production is also simple. The quality of the work is to test all or a random sample of the light bulbs produced and see how many work and compare the percentage with those contained in the log book.

Monitoring of brainwork is difficult for two reasons. First, how does one measure the quantity of brainwork? Attempts to monitor brainwork by, for example the number of pages which an author writes will inevitably lead to long and rambling discourses and will discourage editing. Because of the flexibility of the laser printer, this incentive structure will also lead to the use of page formats which will have the fewest tolerable number of words per page. This obviously leads to a perverse incentive structure for brainwork. The second reason is because quality assessments are subjective. While it is easy to agree whether a light bulb works or not, the beauty of brainwork is largely in the eye of the beholder. Brainwork is like art in that the perceived quality of brainwork is subjective: work which some people honestly believe is awful, can honestly be perceived as brilliant by others.

One can observe the consequences of these difficulties in monitoring. Since monitoring is difficult, smaller units and specialized supervision are often required. The most effective way to do this is to give proper incentives for individuals to monitor themselves through establishing a market price for the brainwork, or alternatively to have monitoring done by an experienced specialist who knows about the nature of the work in addition to "management techniques." The experienced specialist will also have to be monitored. As a result, it is likely that a high percentage of his pay will be linked to the profitability of his subordinates (again at a market price). Since the specialist must get a high percentage of the profits, one should not be surprised that an increasing number of these monitors not only act like owners, but are owners. These problems in monitoring may be a key reason why we are witnessing "the eclipse of the public corporation."²²⁸

Section 6: Changing Cost Structures: Implications for Firms

Chapter 4 was concerned with the trade-off between contracting costs and monitoring costs. Let us now fit this into the framework of the radical changes in the cost structures of contracting and monitoring.

²²⁶ Supra note 13 at 8.

²²⁷ Supra note 1 at 86.

²²⁸ M.C. Jensen, "The Eclipse of the Public Corporation", 67 *Harvard Business Review* 61-74 (September/October 1989).

"Globalizing markets, instantaneous communications, travel at the speed of sound, political realignments, changing demographics, technological transformations in both products and production, corporate alliances, flattening organizations - all these and more are changing the structure of the corporation. The once very rigid and unbridgeable boundaries of business are fading in the face of change."²²⁹

Rising Monitoring Costs versus Falling Contracting Costs

When Coase stated that firms exist because contracting is expensive, he was directly implying that firms will exist when the cost of contracting is lower than the cost of monitoring. As long as contracting is more expensive than monitoring, one can expect firms to exist and prosper. At the time Coase published the article in 1937, and indeed arguably through most of the 1970s, firms tended to become larger because the cost of monitoring was less than the cost of contracting. Through the firm structure, economies of scale were allegedly achieved.

The advent and the diffusion of the microchip has changed this notion. When one couples the reduction in the costs associated with the three contract-forming steps with the decreasing ability to monitor the increased amount of brainwork, one must expect that the way in which firms are run has and will continue to change. For many firms, their entire structure will necessarily have to change when the cost of monitoring exceeds the cost of contracting.

Decentralization, Firm Size, Specialization and Employment

Because of this change in cost structure the world is witnessing increased specialization in the work which firms do. Lower communication and travel costs have allowed markets to become increasingly global. Technology has altered many transaction costs significantly to the point where there is significantly more outsourcing (contracting-out) and decentralization in companies than a few short years ago. As a result, the number of firms has increased and the size of firms has decreased. For example, since 1980 there has been a five-fold increase in the number of American firms with fewer than 10 employees. The average size of firms in America has shrunk by 15 percent over the same period.²³⁰ From 1981-1985, 82 percent of net job creation occurred in firms with less than 20 employees.²³¹ Firms are generally growing smaller and have therefore greatly increased in number.²³²

One of the reasons why firms are getting smaller is that an increased amount of work is being out-sourced.²³³ This change in cost structures has also had an effect on companies which are not shrinking; larger companies

²²⁹ R.M. Kanter, "The Boundaries of Business", Harvard Business Review 151-164 (May/June 1991) at 151.

²³⁰ National Science Foundation, Research Report (Washington, D.C.: National Science Foundation, November 1990) at 12-15.

²³¹ D.L. Birch, Job Creation in America (New York: Free Press, 1987) at 14.

²³² Supra note 2 at 50.

²³³ See i.e. I.W. Sengenberger and G. Loveman, Smaller Units of Employment: A Synthesis of Research on Industrial Organization in Industrial Countries (Geneva: International Institute for Labour Studies, 1988).

are becoming increasingly decentralized. The day of the conglomerate is largely gone,²³⁴ because many of the cost advantages associated with hierarchies have largely disappeared.

Many of those firms which have yet to get smaller have smaller and smaller internal business units. These units are individual "profit centres" which have to operate profitably and even compete for business from the firm.²³⁵ If they cannot produce quality work at a competitive price, their services will not be consumed internally. This process has proliferated because small profit centres provide for the monitoring of managers.²³⁶

The Automobile Industry

Not only are conglomerates selling-off their "non-core industries and business," but the nature of work in core industries is also changing dramatically. In 1913, Henry Ford opened up what at the time was the world's largest factory in Highland Park, Michigan. In one door went iron ore, sand, petroleum, copper and other raw materials. Out the other door came out an automobile which was completely manufactured in the plant. There was no sub-contracting.²³⁷ For a long time the trend in both government and manufacturing was to increase the scope of vertical integration. By integrating vertically, firms could completely control their environment and standardize quality control through the capitalistic equivalent of the command system. A funny thing happened along the way,

Automobile manufacturers, led initially by the Japanese, created working relationships with their sub-contractors. They shared vital information and called on the sub-contractors for an increased share of the design work for the component parts. Over time the Japanese contracted out a larger and larger amount of their component work. They buried the Americans and would probably have buried the Europeans without severe import restrictions in several key markets, with the exception of the German automobile manufacturers. Volkswagen, Mercedes-Benz, BMW and Porsche all proved to be a worldwide exception, possibly because their industry worked within what Michael Porter calls a 'competitive diamond' where a national competition for supremacy emerged "from pressure, challenge and adversity." This competition created a pool of skilled workers, quality-conscious consumers and world-class related and supporting industries - attributes which the Japanese also created.²³⁸ American firms (and French and Italian) were generally initially complacent to the Japanese threat.²³⁹

²³⁴ The exceptions lie in such firms described by Jensen as "LBO partnerships." The LBOs are not run like conglomerates, as there is no real common management. An LBO partnership is a group of separate companies which are run independently by their own sets of managers. The LBO partnership only interferes in the business to the extent that they provide each company's managers with strict sets of financial objectives. Management compensation is highly linked to increases in cash flow which are generated by management performance. In this respect, managers must act like owners. For a full description of the LBO partnership see Jensen, *Supra* note 34.

²³⁵ This is also referred to as "insourcing."

²³⁶ For a discussion why well-managed firms do this see T. Peters, *Thriving on Chaos: Handbook for a Management Revolution* (London: Macmillan Press, 1988).

²³⁷ D. Halberstam, *The Reckoning* (New York: William Morrow and Co., 1986) at 78-95.

²³⁸ M.E. Porter, *The Competitive Advantage of Nations*, (London and Basingstoke: Macmillan Press, 1990) p. 174. For a somewhat similar analysis see J.J. Rotemberg and G. Saloner, "Competition and Human Capital Accumulation: A Theory of Interregional Specialization and Trade", NBER Working Paper No. 3228 (1990).

²³⁹ For an excellent explanation of why the American automobile industry fell at the time the Japanese automobile industry rose see David Halberstam, *The Reckoning*, *supra* note 43.

The Japanese found that in many instances, contrary to what was taught in many business schools, the benefits of sub-contracting out work greatly exceeded the cost of contracting.²⁴⁰ What the Japanese apparently concluded was that in some cases it was too difficult both to foster innovation and to monitor workers within the large firm structure. This recognition that lower costs and improved quality would come not from vertical integration, but through outsourcing²⁴¹ and decentralization,²⁴² made the Japanese automobile manufacturer the envy of the world. As a result of enlightened Japanese management, so called "Japanese transplant firms" located in both the United States²⁴³ and Europe²⁴⁴ have the highest productivity and lowest production costs on their respective continents. As a result of this observation, all automobile manufacturers are sub-contracting out more and more of their component work to the extent that the "manufacturers" are largely becoming service industries.²⁴⁵ The role of these "manufacturers" is becoming increasingly limited to: (1) the operation of screwdriver plants which assemble the bought-in parts; (2) design firms, although designs are also being bought from the outside especially in the area of component parts; (3) marketing firms which work in conjunction with advertising firms; (4) distributors; and (5) finance companies.²⁴⁶

Computers

Similarly, in 1984, 80 percent of the value of a computer was in its hardware and 20 percent in its software; by 1990 the opposite was true.²⁴⁷ This is only half of the equation. The vast majority of the cost of the hardware comes from the provision of services. "The immensely successful IBM personal computer itself comprises a collection of services - research, design, engineering, sales, service; only 10 percent of its purchase

²⁴⁰ Keizo Nagatani wrote that "The most striking feature of Japan's state capitalism was its anti-neoclassical character. Virtually everything Japan did defied neoclassical welfare theory." Political Macroeconomics (Oxford: Clarendon Press, 1989) at 231.

²⁴¹ Out-sourcing can be defined as subcontracting work out to outside suppliers. Yuji Furukawa of Tokyo Metropolitan University estimates that outsourcing now accounts for over one-third of Japanese total manufacturing costs, this is up from less than 20 percent in the 1960s. He estimates that this proportion will rise to 40 percent by the year 2000. "Manufacturing: The Ins and Outs of Outing", The Economist (August 31, 1991) at 58. The Polaroid Corporation is a good example of how prevalent outsourcing has become. Polaroid spends about one-half of its annual revenue on outsourced products, components and services. It deals with more than 8,000 suppliers. With these 8,000 parties it has formed 95,000 contracts. *Supra* note 1 at 99.

²⁴² Reich, *supra* note 1, gives an excellent summary of how decentralization is occurring. See generally chapter 8, "The New Web of Enterprise" at 87-97 and 84-85.

²⁴³ M. Dickson, "Transplant Sales are Overtaking Imports", Financial Times World Car Industry Survey (September 11, 1991) p. 10.

²⁴⁴ K. Done, "Japanese March to Expand Capacity", Financial Times World Car Industry Survey (September 11, 1991) p. 2.

²⁴⁵ "Death of a Car Salesman," The Economist (August 24, 1991) pp. 51-52.

²⁴⁶ Following the American automobile firms, the Japanese are now entering the retail financial services market on a large scale. Toyota is not only going to finance the purchase of automobiles, but will also finance homes, issue credit cards and install cash machines in their dealerships. It will soon be difficult for consumers to tell the difference between a bank and an automobile manufacturer. S. Wagstyl, "Toyota to Expand Into Financial Services Sector", Financial Times (August 29, 1991), p. 1; also see A.H. Mooradian, "Volkswagen Says It Plans to Broaden German Financial Services Business" Wall Street Journal Europe (September 13, 1991) p. 17.

²⁴⁷ *Supra* note 1 at 83.

price is for the physical manufacture of the machine.²⁴⁸ Taken together, in 1990 only about 2 percent of the value of an IBM computer derived from the cost of its physical manufacture. This has led some commentators to ask whether it is worthwhile for many businesses to be involved in the manufacture of computers.²⁴⁹

Basic Heavy Industry

Running alongside outsourcing and decentralization, there has been a shift away from "high volume to high value."²⁵⁰ The steel, plastics, and chemical industries are good examples of this. Formerly steel, plastics and chemicals were considered commodities, measured in tonnes, and were produced in huge factories. Today steel, plastics and chemicals are largely ordered by customers for specific uses, measured by value and are increasingly produced in "boutique" plants. Steel is dipped, painted and cut by the steel making companies and supplied as an out-sourced product for just in time delivery.²⁵¹ Plastic is coloured, cut and made to specific specifications. Specialty chemicals are the ones which have the greatest value. Similarly the fastest-growing and most profitable part of the textiles industry produces specially coated and finished fabrics for automobiles, office furniture, rain gear and wall coverings.²⁵² If old-time heavy, basic industries, such as automobiles are largely becoming service firms and steel, plastics, chemicals and textiles are decreasingly produced in bulk, the world is undergoing a dramatic change.

Service Firms

Changes are not limited to manufacturing firms. Service firms, like advertising agencies, are facing similar problems.²⁵³ Just like governments, one of the major functions of advertising agencies was to accumulate and disseminate information. Modern technology has created several problems for the advertising industry, all of which have allowed advertisers to focus on more narrowly targeted audiences.

Cheaper, easy to use, and higher quality video and audio equipment has allowed more people to make higher quality video and audio products at greatly reduced prices. Desktop publishing and computerized graphics have allowed small children to produce the type of artwork that formerly only a handful of professionals could produce. Satellites and cable television have fragmented the market, ending the monopoly position of large, (formerly mainly government-run) broadcasters. Desktop publishing has led to an exponential growth in the number of specialist publications. The microchip has allowed data bases to proliferate, thus leading to alternative forms of promotion, such as database mass marketing which selects potential customers almost on an individual basis. As a result of these advances in technology, smaller firms who know their market better than some large advertising agencies can now do the work of a large agency at lower cost, with more control and greater expertise. If the trend away from larger agencies continues, eventually what largely may be left are specialized

²⁴⁸ Ibid. at 86.

²⁴⁹ A.S. Rappaport and S. Halevi, "The Computerless Computer Company", 69 Harvard Business Review 69-80 (July-August, 1991). This spawned the debate "Should the U.S. Abandon Computer Manufacturing?" 69 Harvard Business Review 140-160 (September-October, 1991).

²⁵⁰ Outsourcing can be carried too far. Many of the non-Japanese firms have primarily used outsourcing to cut down on their labour costs and overheads. The Japanese use these as secondary considerations. The Japanese tend to outsource only those activities which add little value to the firm; activities which are marginal and hence high-cost; and activities which do not give the firm a competitive edge. *Supra* note 47.

²⁵¹ "Europe's Steel Industry: Crying Foul", The Economist (September 14, 1991) pp. 87-88.

²⁵² *Supra* note 1 at 82-83.

²⁵³ See R.S. Roach, "Services Under Siege - The Restructuring Imperative", 69 Harvard Business Review 82-91 (September-October, 1991); G. de Jonquières, "Wrong Choice From the Menu", Financial Times (September 6, 1991) p. 9.

firms who do not create advertising copy, but merely buy advertising space. These types of firms are currently developing. This type of firm exists because it provides economies of scale. Its costs remain low because this type of agency generally has few or no creative people and low overheads.²⁵⁴

Section 7: Implications for Governments

The changes outlined above have widespread implications for governments. The theory behind large centralized governments was, at least in part, founded on the assumption that a large government could, like large firms, reap widespread economies of scale. The problem which governments are currently facing is that they are also subject to similar contracting and monitoring cost changes. If competitive pressure have forced businesses to react to changing technology and cost structures, one should expect governments to react in somewhat similar ways.

Governments have reacted. Over the past few years we have seen an increasing number of privatizations around the world. In addition to privatizing industries, more and more governmental responsibilities have been contracted out. The services being out-sourced include garbage collection, jails, road building and maintenance and cleaning services.²⁵⁵ Both outsourcing and privatization illustrate that the costs of contracting are less than the costs of monitoring; if this was not true it is unlikely that any of the privatizations would occur, since privatization often means less political power and less control over the economy and the work force (including the ability to dole out patronage jobs).

When countries privatize they have two measurable income streams. Often only one is considered.²⁵⁶ Assuming that the public enterprise makes money, a privatization will be efficient if the sale price is greater than the net present value of the expected profits of the enterprise. If the enterprise is bleeding red ink and has no prospect of having an income stream with a positive net present value, selling will always be efficient. The second income stream is the one which is not often considered. If the enterprise becomes more profitable as a result of private management, the firm will pay higher profits taxes in the future. Additionally, higher income tax revenues will be reaped if managers receive higher salaries and bonuses from the new management.

In comparison with firms, one would expect the government to have an even greater need to out-source work. While firms can set up profit centres which reward managers for their performance, few if any civil services allow performance-based pay. Civil service jobs are largely for life at a set pay scale. Suitable motivation can seldom be provided for public service jobs within the public sector.

This changing cost structure has other consequences for government. At the most fundamental level, technology has reduced and will continue to reduce some of the justification for government intervention in the economy. In the past many activities fell on the government simply because they were difficult if not impossible to accomplish without government intervention. Because of technology in general and modern communications in

²⁵⁴ See M. Mayer, *Whatever Happened to Madison Avenue* (New York: Little, Brown, 1991).

²⁵⁵ For a review of the growth in worldwide privatization in the 1980s, see P.E. Fixer, R.B. Poole and L. Scarlet, *Privatization 1989: Third Annual Report on Privatization* (Santa Monica, CA: Reason Foundation, 1989). The types of services which American state and local governments have privatized include: garbage collection, water and sewer services, child care, data processing, care of the elderly and the handicapped, vehicle maintenance, housing, recreation, traffic signals and lighting, public transportation, utilities, vehicle towing, education, fire protection, road development, tax audits, clinics for spaying and neutering animals, landscaping, janitorial services, hospital care, police protection and jails. *Supra* note 2 at 148.

²⁵⁶ McKenzie and Lee in their review of the privatization literature, for example, seem to recognize only the sale price as governmental income stream. *Supra* note 1 at 148-153.

particular, a number of activities which formerly fell within the exclusive purview of government are increasingly being devolved through privatization.²⁵⁷

A bureaucratic system of management and large centralized governments might have been needed when data was difficult and expensive to collect, collate, interpret and disseminate. As long as this was true, it was efficient to have a small group of people along with their staffs manage information flows and take decisions. As in the case of advertising firms, the day when a bureaucrat, minister or legislator had access to superior information and was able to direct state enterprises to efficiently carry out activities is waning. Previously information had to be sent from local sources to a central office. The central office compiled and manipulated data. It was not available to the general public until the data was typed out, sent to the publisher, proofread and finally published. Raw data and preliminary information was only available to a small group.

Modern communication and computers have changed circumstances dramatically. Today, computerized data bases eliminate the need for most of these steps. The day when few people could have access to diverse information is over. The governmental monopoly has been broken. The result of this is a decentralization of decision-taking. This also allows more people and groups to be involved in the decision-making process. Data can be sent to a data base which anyone in the world with a modem can access. As access to information becomes more available, we should also expect the amount of information available to increase. Increased data means that decisions are more complicated which leads to increased specialization. For the reasons discussed above, increased specialization should lead to decentralization. Under this scenario, the strategy for governments must be to decentralize. When decentralization occurs, while getting smaller at the centre, the size of the regional governments can either also decline for the reason given or become larger if more local specialists are required. By having decisions taken closer to the people, governments can act more efficiently.

The loss of monopoly and the difficulty of monitoring brainwork must be considered in the context of the governmental role of collecting and disseminating information. Instead of having to wait for government publication, results and data bases are continuously updated. Instead of requiring a team of government number crunchers to interpret the data, anyone with access to the data can build his own models and use the raw data himself. If the interpretation of the data has real market value, one can expect that someone in the private sector will hire the better number crunchers, thus leaving the lesser (and more risk adverse) people in the civil service to do the same old job.

This change in the cost structure makes an assertion made by Harold Demsetz outdated. Demsetz argued that governments tend to grow because: "Highly organized groups, because their political power reflects an influence that extends beyond their numbers, generally prefer more, not less, government involvement in the affairs of society."²⁵⁸ When information was more costly to obtain and distribute and the cost of organizing was prohibitively high for all but a few groups this might have been true. Only parties who wanted to see the size of government grow had sufficient incentive and money to lobby. Today anyone with a word processor and a data base has the power to lobby the government. As a result, we have witnessed a large increase in the number of persons and groups attempting to influence governmental decisions. This has two effects. The first is that there are now more groups who want to stop or reduce the growth of government. These often act to counter the highly organized groups which Demsetz had in mind. The second is that there are more groups who have become highly

²⁵⁷ Ibid. at 222-25. The authors point out that technology (i.e. modems and fax machines) is killing off the post office monopoly, even for letters and small packages; the ability to monitor road usage in ways similar to the manner in which the telephone company monitors calls might, in time, make unpriced public highways obsolete; and technology in "natural monopolies" such as electric companies, rail roads, telephone wires and natural gas lines, allows different carriers to monitor usage and so allow competition over the same network. In the case of telephones, mobile telephone technology provides competition to the telephone wire in the same way that satellite dishes directly compete against cable television monopolies.

²⁵⁸ H. Demsetz, Economic, Legal, and Political Dimensions of Competition (Amsterdam: North Holland, 1982) at 99.

organized. This dilutes the message of all those groups who would like an expansion of government size, services and control.

The Fall of the Soviet Empire

In retrospect, it is hard to imagine any invention that could have led to a quicker demise of the Soviet system of government than the microchip. Totalitarian governments need to control flows of information to perpetually remain in power. The Soviet government fully realized this. Typewriters, copiers and printing presses were kept under strict party control.²⁵⁹ Maps and telephone directories were considered state secrets. Not surprisingly, the Communist Party delayed the introduction of the computer for non-military use as long as possible. Because of this delay, all of Eastern Europe fell further and further behind the West. While the West transformed itself from a manufacturing economy to a service economy, the Soviet Union and its satellites remained tied to their bureaucratic and totalitarian ways.

Mikhail Gorbachev's failure of leadership sprang from his inability to successfully monitor and motivate workers at almost every level. When he came to power, he was faced with only two real choices: either remain the leader of a totalitarian empire or to initiate radical reforms. If the Eastern Bloc was to retain its complete control over the lives of its citizens, Gorbachev instinctively knew that its relative economic (and military) power would have to decline. His first act of control was to attempt to increase discipline in the economy by talking tough and rationing alcohol. Because Gorbachev was unwilling to act in a Stalinist manner, these actions had little direct economic effect other than to slash the considerable government revenue which the sale of vodka provided. Restricting vodka, one of the few available joys of the average Soviet citizen, brought nothing but hostility from the vast majority of the populace.

While Perestroika can be seen as a partial response to the West's new challenge, it was also a response of the failure of Gorbachev's initial policies. Whether the decline (vis-à-vis the West) of the East Bloc was absolute or merely relative makes little difference: as long as the West was going to become computerized and the East was not, the East was going to fall further behind. Perestroika was almost a necessary condition for the Soviet system to introduce computers - what was missing were the types of incentive structures necessary to run a service-based economy. It is difficult to conceive successfully running a large, all-encompassing bureaucratic structure without having proper monitoring tools for workers who provide specialized services. In the end, the Soviet system could not survive as a major world power because the system and the leadership could not properly motivate the majority of the population to do the jobs which were assigned to them.

Section 8: Competitive Governments

Microchips have the tendency to destroy bureaucracies since they effectively shift information (and power) from leaders at the top of organizations to smaller groups and individuals. Governments have, in at least some respects, lost the power to dictate policies to the extent that non-governmental employees often have better information than any government official or group of governmental officials. If knowledge is power, the end of the government monopoly on the provision and dissemination of information ultimately leads to a lack of control. For the same reason that perestroika ultimately led to the end of the grip of communist rule in Eastern Europe and the former Soviet Union, the microchip and modern telecommunications have led to the loss of governmental

²⁵⁹ In 1982, U.S. President Ronald Reagan reportedly approved a plan in conjunction with Pope John Paul II to secretly supply Poland's outlawed Solidarity Movement with fax machines, presses, transmitters, telephones, video cameras, photocopiers and computers. The two leaders were convinced that if Poland became a democratic country, other Eastern European countries would follow, causing the Communist Bloc to collapse. This strategy apparently worked. Solidarity is credited with setting into motion the fall of the Soviet Empire. It is ironic that the closing battle of the Cold War was fought on the basis of relatively low-cost information-based technology, not large military expenditures. K. Schneider, "Reagan Reportedly Ordered Covert Aid to Solidarity to Destabilize East", International Herald Tribune (February 19, 1992) p. 3.

control over the flows of investment capital. Unfortunately for governments, once the genie is let out of the bottle, governments cannot get it back in.

Firms and individuals recognize this. Increased mobility of people, communication and information²⁶⁰ allow groups, firms and individuals who do not like a government's policies to move to a jurisdiction which will provide a more hospitable climate.²⁶¹ It is precisely this mobility which makes it necessary for governments to compete with each other to provide the best investment and living climate. The microchip and other world developments "made capital as slippery and as elusive as quicksilver, and the growing transnational mobility of capital forced world governments to become competitors for the globe's expanding capital base - by cutting tax rates, curbing unnecessary and wasteful expenditures, eliminating inefficient regulations, and renouncing all the trappings of state central planning." At the same time the "knowledge, which economists call 'human capital,' has necessarily become a relatively-more-important source of economic power and income."²⁶²

As a result of this changing cost structure, governments have been forced to lower tax rates, deregulate industries and privatize industries and services so that interjurisdictional productive facilities can remain competitive in a worldwide market.²⁶³ This is even true in the third world.²⁶⁴ After all, the privatization of services is exactly the same concept as outsourcing. This internationally competitive environment has contributed to a loss of both fiscal and regulatory control which has led to a large decrease in governments' ability to govern in the fashion which they have for the last 50 to 75 years. While this trend may have been unnoticed by many, one only has to look in today's newspaper to see another example of a country or local or regional government which is under severe budget constraints. This is true in North America, South America, Western Europe, Eastern and Central Europe, Africa, Asia,²⁶⁵ Australia and New Zealand. After a decade of growth, one must ask why virtually every country has been simultaneously stricken by budgetary crises. Despite some claims that

²⁶⁰ Electronic blips that represent money are extremely important bits of information.

²⁶¹ This is not necessarily for the public good, as the Bank of Commerce and Credit International (BCCI) scandal illustrates.

²⁶² Supra note 2 at 9.

²⁶³ The rationales espoused for lowering subsidies and deregulating differ. One of the more interesting set of reasons comes from the German Economics Minister, Jürgen Möllemann. He contends that cutting subsidies and reducing regulation should not be done for their own sake; they should be done to stop hypocrisy. He maintains that the west cannot preach free markets for the east and have protected and subsidized markets in the west. J.W. Möllemann, "To Rebuild the East, the West Will Have to Change", International Herald Tribune (September 20, 1991) p. 6. A similar argument is given by J. Flom, "Double Standards by the US", Financial Times (September 19, 1991) p. 22.

²⁶⁴ From 1986 to 1991, the conventional wisdom that first world countries would deregulate while the third-world would remain protectionist has been stood on its head. During this time period, among the 102 members of the General Agreement on Tariffs and Trade (GATT), some 30 developing countries - not including the former communist block countries - have unilaterally slashed trade barriers, often as a part of broader market-based economic reforms. The countries deregulating their economies range from impoverished Bangladesh to the emerging power South Korea. Over the same period, trade protectionism has increased in the richest countries - notably in the United States and in the European Community. The GATT has counted 284 discriminatory export-restraints imposed by these countries as a condition for market access. This does not include the increased use of anti-dumping measures. "Third-World Trade: Preaching to the Converted", The Economist (September 21, 1991) p. 84.

²⁶⁵ For an interesting report of how this trend is affecting India and Pakistan see S. Coll, "Indian Subcontinent Tackles Capitalism", International Herald Tribune (September 9, 1991) p. 2.

government taxation²⁶⁶ and regulatory powers²⁶⁷ are virtually unlimited, this clearly is not the case. To the contrary, modern technology seems to be serving as a liberating force easing the institutional constraints on individual decision-making.

While governments are faced with demands for increased public spending, the amount which they can raise is certainly limited and higher taxes have significant costs. Countries which lowered tax rates in the 1980s found that their revenues did not suffer and often increased.²⁶⁸ At least in some instances the Laffer curve, which shows that lower tax rates can lead to higher revenue, has proven to be correct.

Many of the bills for the promises made during the post-World War II boom period are coming due. Populations are living longer. The costs of pension benefits and health care are increasing daily. The numbers of workers paying into the health care and social security systems are either declining or are remaining relatively steady.²⁶⁹ Countries as diverse as the former Soviet Union, Brazil, China, Italy, the United States and the Netherlands either have or are seriously discussing breaking previously made "social contracts" in the light of changed conditions. The problem which governments are facing is that with the emergence of "quicksilver capital" the government's ability to raise additional revenues is clearly limited; if one raises taxes, at least some capital flight will occur. This does not mean that additional revenues will not be raised, but it does mean that at least marginal investments will in the future be made in jurisdictions offering better rates of return on an after-tax basis. The loss of marginal investment will lower economic growth and potential tax revenues.²⁷⁰

Within this competitive environment for tax revenues, tax payers will increasingly demand value for money from their governments as governmental power gets weaker and weaker and the demands on government become greater and greater. This leaves governments with a limited number of options.

Section 9: What Governments Can Do

The options for government are indeed limited because, as Michael Porter states: "Governments do not control national competitive advantage; they can only influence it."²⁷¹ Government actions which may positively influence national competitive advantage may have the unfortunate consequence of reducing efficiency in the

²⁶⁶ i.e., G.A. Norton, "The Limitless Federal Taxing Power, in J.D. Gwartney and R.E. Wagner (eds.), Public Choice and Constitutional Economics (Greenwich, Conn.: JAI Press, 1988) pp. 253-84.

²⁶⁷ F.A. Hayek worried that governmental powers could only increase. He worried that, as a result of this, individuals and nations were on The Road to Serfdom (Chicago: University of Chicago Press, 1944).

²⁶⁸ Supra note 9.

²⁶⁹ France, which has a virtually universal, unfunded state pension programme, is just one example of a country which is facing major difficulties. Demographic forecasts predict that by the year 2020 there will be more people of pensionable age in France than there will be working to support them. This threatens to throw the system into chaos. The obvious solution is to follow the example of countries such as the Netherlands and the United Kingdom which encourage private pensions. This, however, has its own circular problem: pension payments for retired workers who contributed to the system still have to be made, should workers invest in their own private pensions. Workers who pay for a earlier generation's pensions expect a quid pro quo, namely their own state pensions. A. Rawsthorn, "Super-Béré Lights Pension Touchpaper", Financial Times (January 13, 1992), p. 3.

²⁷⁰ "Many of the tax battles were won in the 1980s, but unfortunately the war isn't over. The drumbeat for new taxes is continuing on Capital Hill. When will Washington learn? When you tax production and growth you get less of both." Ronald Reagan as quoted in "Notable & Quotable", Wall Street Journal Europe (August 20, 1991) p. 10.

²⁷¹ Supra note 44 at 617.

manner described in Chapter 1. As Porter goes on to say: "The central goal of government policy toward the economy is to *deploy a nation's resources (labor and capital) with high and rising levels of productivity*...Productivity is the root cause of a nation's standard of living. To achieve productivity growth, an economy must be continually upgrading....The proper role for government policy toward a nation's industry is to stimulate such dynamism and upgrading....One manifestation of an upgrading economy is the movement of less productive jobs to other nations via foreign investment and foreign sourcing....As we will see, many of the actions which governments take to 'help' industry from the perspective of a narrow static view of competitive advantage can actually hurt in the long run....The most potent influences of government in advanced nations are often slow and indirect."²⁷²

While the number of policies which governments can adopt to make their economies more efficient in an international context is limited, there are some. Porter lists various factors which governments can affect positively. These include upgrading education, training, science, technology and infrastructure, promoting an efficient capital market and a stable currency, providing information to industries, and providing direct and indirect subsidies and tax incentives.²⁷³

Porter concludes from an exhaustive study on the competitive advantage of nations is: "Government's proper role is as a pusher and a challenger."²⁷⁴ The proper role for governments is to enhance, not restrict competition. Restricting competition is a short-term solution. Competition creates the correct incentives and motivation. Competition also helps the monitoring process.

The question must be asked: can industrial policies work in this environment? The answer is probably no, for two related reasons. First, industrial policies usually lead to a reduction in competition. In the extreme case of communism as formerly practised by the former Soviet Union, China and their satellites, we learned that to the extent that governments did not compete for resources, but rather attempted to control them, their citizens got relatively poorer and poorer. This largely explains why virtually every country in the world, communist and capitalist, is either discussing or actually privatizing state-owned industries and deregulating others. This further decreases the government's ability to control the economy. Second, industrial policies usually hurt consumers as they rely on subsidies or higher domestic prices or both.²⁷⁵

What then can governments do? The first question is: what *should* governments do? With the fall of communism one can say with confidence that the type of government which citizens live under matters. According to Robert Reich, governments must be judged according to how well their citizens live, both in monetary terms and in

²⁷² Ibid. at 617-19.

²⁷³ Ibid. at 626-44. Porter notes elsewhere that direct subsidies to industries are often associated with chronic disasters and attempts to save jobs rather than with positive government effects on industry. See chapters 4-9 at 179-481 for examples.

²⁷⁴ Ibid. at 681. Nagatani discusses differences in national economic styles and compares the roles of the Japanese and the Canadian policy-makers. "In Canadian politics one does not sense the strong will of the national policy-makers. Policy debates are ever popular and many ideas are actually tried, but these attempts are tentative and often ineffectual. One fails to see any degree of intertemporal consistency in Canada's national economic policies. New ideas constantly make headlines; royal commissions are set up one after another on issues of any significance in order to crystallize public opinions into policy guidelines; and yet a master policy plan is never drawn up. Canadians' small-open-economy mentality and their affluence may explain this lack of determination." *Supra* note 46 at 230.

²⁷⁵ The European Community's attempt to proscribe its standard of high definition television might cost European consumers as much as ECU 21bn (\$24.4bn) according to a report by Coopers & Lybrand commissioned for two private groups of broadcasters, Esselt and VPRt. This was reported by A. Hill, "EC's new TV Strategy 'Will Cost Consumers ECU 21bn'", *Financial Times* (August 30, 1991) p. 1.

terms of quality of life, and whether this standard of living can be maintained or improved upon in the future.²⁷⁶ In looking toward the future, governments must stop thinking in terms of the past. It will be difficult to overcome the inertia of centralized government. In business, "company structures have changed as a result of downsizings, reorganizations, CEO changes, mergers, acquisitions, and divestitures. Yet hierarchy still rules the industrial organizations and the split between the upper-level manager and the work force is as large as ever. Why? Because companies are reluctant to embrace the logic of the technology and dismantle the walls that separate levels of management."²⁷⁷ If businesses are slow to adapt, one would expect that government bureaucracies would be even slower moving dinosaurs.

One good way to begin this process is to stop thinking of the nationality of a company solely in terms of where a company is incorporated or where its top management lives. As discussed above, modern communications and travel have made it increasingly less expensive to conduct business with virtually any and every part of the globe. Partially as a result in the change in the cost structure, most larger-sized companies today are multinational in both scope and outlook. Many increasingly have operations in several countries over a large area of the world. Managers have realized that to remain competitive, it is imperative for companies to produce and provide goods and services where they can generate the highest levels of quality and service at the lowest cost. Competitive companies have become engaged in so many countries that it is difficult to attribute the corporation to any particular country. This to the extent that Reich asks two questions: "Who is Us?"²⁷⁸ and "Who is Them?"²⁷⁹ To help clarify these questions, Reich gives the example of two successful corporations with an American presence.

Corporation A is headquartered in the United States. Most of its directors, shareholders and top managers are American. Most of its employees are non-American. The company undertakes most of its research and development, product design and manufacturing outside the United States. Within the American market, an increasing amount of the company's product comes out of its non-American based laboratories and factories. Corporation B is headquartered abroad and all of its directors, shareholders and top managers are non-Americans, but most of Corporation B's employees are American. The Company undertakes most of its research and development, product design and manufacturing in the United States. The company exports most of its production, even back to the country where Corporation B is headquartered. In a dispute between the two companies, Reich asks, which is more entitled to governmental support? His answer is that the headquarters and incorporation of the company make little difference. The country's future prosperity is clearly more in the hands of the "non-American" corporation. The issue should be couched in terms of what the country can do to attract investment and skills.²⁸⁰ So who is us? Management guru Kenichi Ohmae provides the following answer: "It is a twenty-first century fact that any institution that does business and pays taxes within a country is a legitimate corporate citizen of that country. It is a full dues-paying participant in the economy, with all the rights and all the obligations that entails. Where it's headquartered makes no difference. The native language of the CEO makes no difference. It is a legitimate part of the economy of the host nation. What is the point of even trying to distinguish between foreign and indigenous companies? If your goal is to enhance the well-being of your citizens and to boost freedom of choice, why do such distinctions matter?"²⁸¹ Governments do not like the

²⁷⁶ *Supra* note 1 at 244.

²⁷⁷ J. Jaikumar, "The Boundaries of Business: The Impact of Technology", 69 *Harvard Business Review* 100-1 (September-October 1991) at 100.

²⁷⁸ R.B. Reich, "Who is Us", 68 *Harvard Business Review* 53-64 (January-February, 1990).

²⁷⁹ R.B. Reich, "Who is Them?" 69 *Harvard Business Review* 77-88 (March-April, 1991).

²⁸⁰ *Ibid.* and *supra* note 84.

²⁸¹ K. Ohmae, "The Boundaries of Business: The Perils of Protectionism", 69 *Harvard Business Review* 128-30 (July-August 1991) at 130.

borderless organization - they like to know who is in charge.²⁸² While global competition is not something that is new,²⁸³ the development of the borderless firm demands different thinking and strategies by both governments²⁸⁴ and firms²⁸⁵ since the new global economy renders the old forms of negotiating, bargaining and keeping score obsolete.²⁸⁶

The answer to what a country can do to improve its competitiveness lies in the analysis contained in Chapter 1: governments can make investments which will have a positive net present value. These include expenditures on both physical capital (infrastructure) and human capital (labour). It is not completely free to enact regulations which maximize satisfaction as the country must realize that it must compete with other countries for a relatively fixed supply of scarce investment capital. Carlos Menem, the president of the formerly economically closed country of Argentina, deftly makes this point when he argues that: "There is no flag on capital....I ask myself, what is national capital? Is it the \$50 billion in flight capital that has left the country via Argentine business executives? Or resources used by multinationals to produce here?"²⁸⁷

In the long run, only governments which adequately educate their work forces at a competitive cost and provide infrastructure efficiently will attract the type of investment which creates high-paying jobs. Porter states that government leaders have a role to play in creating and elevating the competitiveness of the country as an item on the national agenda. He cites Germany, Japan and Korea as countries which have leaders who have enunciated the necessity to succeed in an international environment; these countries are directly contrasted with the United States and Great Britain. The United States and Great Britain are mentioned as two examples of countries which have rested on their laurels too long and whose leaders who cite unfair competition rather than focus on the problems to be solved at home as the main source of their relative decline.²⁸⁸

In the context of increasing international competition, illiberal laws and regulations will necessarily lose out. Trade unions will probably call much of this process "social dumping." To the extent that currently employed workers lose out they are right. But as history shows, when some of the trade guilds were broken-up, a loss for one segment of society may produce large gains for the rest of society.²⁸⁹ If liberalization is the cost for a country, it is a cost well worth paying. The cost of not liberalizing the labour market will be fewer jobs and less growth for future generations. To the extent that unions respond with disruptive strikes over the loss of 'favourable' benefits, hours and working conditions, the cost to future generations will be increased. Trade unions and other special interest groups who are engaged in 'rent seeking' will have trouble not only in extending their

²⁸² Y.L. Doz, "Government Policies and Global Industries", in M.E. Porter (ed.), Competition in Global Industries (Boston: Harvard Business School Press, 1986) pp. 225-66 at 232.

²⁸³ See A.D. Chandler, Jr., "The Evolution of Modern Global Competition", in M.E. Porter (ed.), Competition in Global Industries (Boston: Harvard Business School Press, 1986) pp. 405-448; and O.E. Williamson, "The Modern Corporation: Origins, Evolution, Attributes", 19 Journal of Economic Literature 1537-1568 (1981).

²⁸⁴ D.J. Encarnation and L.T. Wells, Jr., "Competitive Strategies in Global Industries: A View from Host Governments", in M.E. Porter (ed.), Competition in Global Industries (Boston: Harvard Business School Press, 1986) pp. 267-290.

²⁸⁵ A. Mahini and L.T. Wells, Jr., "Government Relations in the Global Firm", in M.E. Porter (ed.), Competition in Global Industries (Boston: Harvard Business School Press, 1986) pp. 291-312.

²⁸⁶ *Supra* note 85 at 84.

²⁸⁷ Quoted by R.B. Reich, *Ibid.* at 85.

²⁸⁸ *Supra* note 44 at 681.

²⁸⁹ *Supra* note 64 at 108-110.

current levels of 'rent,' but also in maintaining their privileged positions. Rent comes in the form of wages above market levels and unsustainable social security benefits and working conditions.²⁹⁰

Much of the analysis outlined above should raise some large concerns. The questions asked by trade unions and others under this condition is: how can we stop international competition? The answer may be harmonization. For example, the European Commission's attempt at a social charter is largely based on preventing social dumping in the European Community. The question has to be asked whether this type of multinational coddling increases national efficiency? To the extent that it may slow down the deregulation process, the answer in the short term might well be affirmative. In the longer term the answer is clearer: it will not.²⁹¹ The only way to stop international competition is to close off one's borders to imports. India, Brazil, Rumania, North Korea, Mongolia, Albania and Myanmar (Burma) have tried to do this. By objective standards none of these countries was even remotely successful.²⁹² If Europe was to form a fortress around itself, it could not stop people from moving to less restrictive countries: the people most likely to move are those with the highest skills and the greatest entrepreneurial talents.

Perhaps Kenichi Ohmae best sums up what governments can do to efficiently manage their country's affairs in an international context. "That government is best that governs least, in terms of economic well-being. The more effective it is, the less it does - at least directly. Yes, it should provide for education. Yes, it should hold companies to ethical standards of behaviour. Yes, it should protect the natural environment. But no, it should not allow itself to be caught up in the fair-sounding arguments that inevitably lead to a downward spiral."²⁹³

Section 10: Conclusion

A reasonable question to ask is whether there is a natural end to this process. One may ask whether man, once he has obtained great material wealth, will be interested in acquiring more. If the answer is no, we should have little concern over the economic migration of capital and workers. In 1928, Maynard Keynes predicted that within 100 years, the standard of living in Western Europe and the United States would be between four and eight times as high as in 1928.²⁹⁴ After sixty years, in 1988, the real GNPs of the U.S., the EEC and Japan (not adjusted for higher populations) were between 3½ and 18 times as high as in 1928.²⁹⁵ Keynes said that since no one could sensibly wish to consume four to eight times as much as in 1928, people would come to recognize the pursuit of money for "what it is, a somewhat disgusting morbidity, one of those semi-criminal, semi-pathological propensities which one hands over with a shudder to the specialists in mental disease....For the first time since

²⁹⁰ The positions of trade unions and employees may diverge widely. Trade unions may be against technological improvements which lead to changes in employment patterns. The Japanese factories which have automated the most are precisely the ones that still offer their workers jobs for life. *Supra* note 13 at 15.

²⁹¹ This is the primary motive behind Great Britain's refusal to sign onto the Social Chapter of The Treaty of Maastricht. The United Kingdom provides less social protection than other northern European countries. It has also been the largest host to non-EC based foreign investment. The government feels that its leading position would be undermined if European social standards were harmonized.

²⁹² "If a nation and its peoples are to flourish, industry must flourish as well. Not much argument here. But to flourish today means to participate actively in the global economy of our increasingly borderless world. No modern country can afford to close itself off from the international flow of materials and technologies. Nor can it afford to deprive its citizens of the opportunity to purchase the best products at the lowest prices, no matter where they come from." *Supra* note 87 at 128.

²⁹³ *Ibid.*

²⁹⁴ *Supra* note 13 at 15.

²⁹⁵ *Ibid* at 5.

his creation, man will be faced with his real, his permanent problem - how to use his freedom from pressing economic cares, how to occupy his leisure, which science and compound interest will have won for him, to live agreeably and wisely and well." While there is increasing concern for the environment and the quality of life, there is little evidence that man has exhausted his will or his ability to spend more. While man generally has much shorter working hours and longer vacations, many would like to work even less. In short, man has not yet sated his desires to earn more money and to work less. As long as this is true there will be increased pressures put on governments to provide efficient (in the terms described in Chapters 1 and 2) laws, regulations and investment. Is this feasible?

The rest of this book shall focus on how the changes outlined in this chapter have transformed the determination of efficient law. The inability of governments to stem the outflow of information, and to a lesser extent people, has marked consequences. Supply-side law is discussed in Chapter 6. The idea of supply-side law is that firms and individuals have increased freedom to pick the law that suits their needs. For example, today almost everyone knows of at least one person who has taken advantage of abortion, divorce, bank secrecy or recreational and medicinal drug laws in another jurisdiction. While many of these laws were intended solely for a country's own citizens, other laws, such as bank secrecy and divorce laws, have been largely created and maintained for the purpose of attracting international clientele. Along the same lines, people are today much freer to pay taxes in the jurisdiction of their choice. As a result, countries which have higher taxes will lose at least some of their former taxpayers. Therefore countries today have two problems. The first is how to retain their current (and future) tax base; the second is how to attract the quicksilver capital and turn it into local investment and tax revenue.

As noted at the beginning of this chapter, history shows us that we are in a period in which strong sovereigns are out of fashion. The expectations of government and correspondingly government expenditures have grown immensely over the last wave (see chart below). The role of government has changed as well. Government is now expected to provide for the citizens; in the past the citizens were expected to provide for the sovereign. Governments are in the process of being squeezed in two distinct directions; both at least due to improved technology. On one hand, governments have created the expectation that they will provide for the sick, the elderly, the handicapped, the young and the unemployed at a reasonably high level. Technology has changed the nature of work, in that the days when many jobs could be created for low-skilled workers are past²⁹⁶ - this means that governments are expected to provide more and costlier training. While retirement ages have not risen from those chosen fifty or more years ago, advances in knowledge, diet and medicine have allowed people to live longer. Longer life spans, coupled with increased terms of education and unemployment, allow many pensioners to receive larger benefits for substantially longer periods than they have paid into the system.²⁹⁷

In addition, advances in medicine cost more than older less sophisticated treatments. On the other hand, governments are also getting squeezed on the revenue side.²⁹⁸ Quicksilver capital has generally led to lower

²⁹⁶ "We are experiencing an acceleration of change that makes the Industrial Revolution of the eighteenth and nineteenth centuries, whose hardships we have read so much about, seem a rather slow process. Blue-collar work is disappearing faster than farming did two centuries ago." M. Crozier, "The Boundaries of Business: The Changing Organization", 69 *Harvard Business Review* 138-140 (July-August 1991) at 138.

²⁹⁷ These twin problems are described by the Organization for Economic Cooperation and Development as the "demographic time bomb", and by U.S. analysts as the "monumental mismatch between jobs and the ability of workers to do them." S.A. Hewlett, "The Boundaries of Business: The Human Resource Deficit," 69 *Harvard Business Review* 131-133 (July-August 1991) pp. 131. For a description of the problems facing France's national pension scheme see note 75.

²⁹⁸ The amount of debt is exploding. In economies that were generally expanding, outstanding central government and government agency debt in the 15 largest industrial countries rose by 14% in 1990 after growing 0.7% in 1989 and 7% in 1988. The trend is expected to increase. M.R. Sesit, "Major Countries' Rapid Pace of Borrowing Yields Worrisome Effects, Economists Say", *Wall Street Journal Europe* (September 30, 1991) pp. 9-11. The figures on the table greatly understate the growth in the size

tax rates. Advances in family planning and job-saving technologies have reduced the number of contributors to the social security systems at a dramatic rate.²⁹⁹ An additional pressure comes from environmentalists. Environmentalism is growing. Many environmentalists ask whether economies either can or should continue to grow as the cost to the environment and quality of life are under threat. This puts governments under another threat. The difficulty in financing current or expanded government transfer payments will almost necessarily increase. Breaking or modifying existing social contracts will be painful - but necessary. Some countries, including Italy,³⁰⁰ New Zealand³⁰¹ and Brazil,³⁰² are already discussing raising the retirement age and decreasing pensions. As the leader of the Swedish centrist Liberal Party (Folkpartiet) said after the Social Democrats had been swept out of power for the first time in 46 years: "it is no longer a question of politicians running the economy, it's the economy running politics."³⁰³

The waves of increasing and decreasing government powers over the centuries should warn us that there is nothing fixed about government. It would not be surprising if the changes seen above flow on to change the extent and function of government in ways which cannot now be foreseen. While making predictions is dangerous, one can foresee a legacy of broken expectations which could lead the wave of history in one of two extreme directions. It could initially lead to such scepticism of government that the citizens desire as little government as possible. This emotion could arise if a reading of contemporary history shows that governments could only make promises which cannot be fulfilled: bigger government cannot help current or future generations.

The second possible direction may come either initially or after the first possibility comes to pass and results in intolerable anarchy. Under this scenario, citizens would demand stronger government, probably from strong populist or nationalistic leadership. This could happen if people come to the conclusion that it was not the government system that let them down, but the inherent weakness of the system and the people who ran it. Should either of these scenarios happen, one must remember that man would be merely witnessing the next wave in a sea of history.

Appendix (See after this chapter)

of government. In 1955, many governments were reducing their high debt levels incurred as a result of World War II. Today deficit spending is large in most countries.

²⁹⁹ This trend is dramatic. From 1976 to 1986, the number of workers between the ages of 20 and 34 in the United States grew by 5 million. By contrast, the number of similarly aged people entering the work force between 1986 and 1996 will decline by 5 million. T. Redburn, "America at Work: Fewer New Jobs But Higher Pay", International Herald Tribune (September 9, 1991) p. 1. The prospects for America are somewhat better than the prospects for Western Europe. American birth rates did not fall as low as European ones. Additionally America has taken in more immigrants relative to the size of the population. Between 1985 and 2000 the number of young men entering the work force annually will drop by 17% in Great Britain, 9% in France, 27% in the Netherlands, 32% in Italy, 18% in Spain, and 38% in Germany. Supra note 103 at 132.

³⁰⁰ H. Simonian, "Popular Pessimism is the Driving Force", Financial Time Italy Survey (June 6, 1991) p. III/1.

³⁰¹ "Roger's Daughter", The Economist (August 3, 1991) p. 54.

³⁰² "Big Country, Big Constitution", The Economist (September 14, 1991) pp. 55-58.

³⁰³ B. Westerberg as quoted by S.D. Moore, "Swedish Conservative Begins Attempt to Form Coalition", Wall Street Journal Europe (September 17, 1991) p. 2.

Appendix: Summary

TABLE 1: TOTAL TAX REVENUES AS A PERCENTAGE OF GDP IN OECD COUNTRIES 1955-1989

	1955	1960	1975	1980	1985	1989
Australia	21.6	22.4	27.6	28.5	30.0	30.1
Austria	30.0	30.6	38.6	41.2	43.1	41.0
Belgium	24.0	26.5	41.8	44.4	47.6	44.3
Canada	21.4	23.9	32.4	31.6	33.1	35.3
Denmark	23.4	25.4	41.4	45.5	49.0	49.9
Finland	26.8	27.7	35.1	33.0	37.0	38.1
France	N/A	N/A	26.9	41.7	44.4	43.8
Germany	30.8	31.3	35.7	38.0	38.0	38.1
Greece	N/A	N/A	25.5	28.4	35.1	33.2
Iceland	N/A	N/A	31.4	30.5	28.9	33.8
Ireland	22.5	21.9	31.5	34.0	38.2	37.6
Italy	30.5	34.4	26.2	30.2	34.4	37.8
Japan	17.1	18.2	20.9	25.4	27.6	30.6
Luxembourg	N/A	N/A	39.2	41.0	44.0	42.4
Netherlands	26.3	30.1	43.7	45.8	44.9	46.0
New Zealand	27.0	27.4	31.3	33.1	34.1	40.3
Norway	28.3	31.2	44.9	47.1	47.6	45.5
Portugal	15.4	16.3	24.7	28.7	31.6	35.1
Spain	N/A	14.0	19.4	23.8	28.8	34.4
Sweden	25.5	27.2	43.6	49.1	50.4	56.1
Switzerland	19.2	21.2	29.6	30.8	32.4	31.8
Turkey	11.9	11.5	20.7	21.7	19.7	29.0
U.K.	29.8	28.5	35.5	35.3	37.9	36.5
U.S.	23.6	26.5	29.0	29.5	29.2	30.1
Unweighted Average	24.0	24.8	32.8	34.9	36.9	38.4

Source: Revenue Statistics of OECD Member Countries 1965-1990, (Paris: OECD, 1991).

Chapter 6: ***Supply Side Law***

Abstract

Governments are faced with the problem of how to attract revenue in a world where capital flows at the speed of light, at the flick of a switch. In the past governments have largely used tax policies and other investment schemes to attract internationally mobile capital. These inducements amount to little more than bribery. There is another instrument which in the past has been largely neglected; the provision of favourable or liberal laws. Some supply-side laws are primarily enacted for the benefit of people who are constricted in the straight-jacket of local national law and would like to find a cheap and convenient alternative. This chapter identifies various kinds of non-tax and supply-side laws, other than direct investment policies, which countries have used to augment employment, investment and government revenues. It also explains the economic motives for providing this type of law.

Chapter 6: Supply Side Law

"New technological developments in 'on-line' systems, electronic communication and satellite broadcasting, and increased circulation of people in the single market, are increasingly challenging the logic and practicality of frontiers drawn between different national and regional regulations."³⁰⁴

"The new global manager's job is to exploit the opportunities created by the high-powered technologies of worldwide communication and transportation and by the relaxation of national controls over cross-border flows of capital. The global manager efficiently deploys capital all around the world, seeking the highest returns for shareholders or partners. Competition is intense and growing. The global manager who fails to take advantage of global opportunities will lose profits and market share to global managers who do."³⁰⁵

In a world which has been revolutionized by technological changes, international managers are presented with increased opportunities to cross borders and to make either financial or physical investments, and to hire and locate workers. Managers and individuals can also increasingly search the globe for optimal laws and tax policies. All changes, especially dramatic ones, present both challenges and opportunities for governments. Responsive governments have taken measures to benefit from these changing circumstances by coming up with various laws and schemes designed to attract internationally mobile capital and investment.

New technologies present countries with two problems. The first is how to retain their current (and future) tax base; the second is how to attract the quicksilver capital and turn it into local investment and tax revenue.

These challenges have led most governments to focus their attention on providing tax breaks and various types of investment subsidies. There is however another alternative. Countries can also use their legal structure to attract capital by supplying law. The idea of supply-side law is that firms and individuals now have a greater freedom to pick the law that suits their needs. For example, today almost everyone knows of at least one person who has taken advantage of gambling, abortion, divorce, bank secrecy or recreational and medicinal drug laws in other jurisdictions. Some supply-side laws can be identified by their "brand names." Who has not heard of a Las Vegas marriage; a Haitian divorce; Dutch recreational drug laws; Mexican medicinal drug laws; Liberian tankers; Greek ships; Swiss bank accounts; Luxembourg holding companies; Delaware corporations; or breaking the bank at Monte Carlo. All are examples of supply-side law as the laws themselves are magnets for some people to use laws which are not provided by their own national government.

In Chapter 2, efficient domestic commercial law was defined in terms of simultaneously minimizing risk, uncertainty and transaction costs while maximizing societal satisfaction by setting minimally acceptable standards. What was not emphasized was, while domestic laws may be efficient for a country as a whole, it is unlikely that they will universally satisfy the needs of all individuals and firms. When the world was local in nature, firms and individuals had little choice regarding the law under which they had to operate. Advances in technology have lowered the cost and availability of worldwide travel and communications. This has made it more feasible for firms and individuals to take advantage of laws which better suit their needs. In a changing world where borders mean less and less, efficient law in an international arena may be different from efficient domestic law.

In this context it is possible to think of a country's competitiveness in terms of its legal structure. Surprisingly, the World Economic Forum on World Competitiveness, which uses several hundred measurements to gauge a country's competitiveness, pays scant attention to the friendliness of the legal

³⁰⁴ European Community statement as quoted in C. Goldsmith, "Brussels to Consider EC-Wide Gambling", *International Herald Tribune* (October 12, 1991) p. 13.

³⁰⁵ R.B. Reich, "Who is Them?" 69 *Harvard Business Review* 77-88 (March-April, 1991) at 78.

environment when assessing the relative competitiveness of countries.³⁰⁶ This is increasingly a mistake. This chapter will identify a large number of legal policies, not directly related to tax or investment, which countries have enacted which may make them more 'competitive' than others. Many of these laws have the effect of attracting internationally mobile firms and individuals. Certain laws are alluring because more liberal foreign laws may better suit the needs or desires of (at least some) firms and individuals than domestic law. Supply-side law can and should be used as an additional measure of a country's competitiveness.

While many of these supply-side laws, such as abortion laws, recreational drug laws and marriage laws may have been intended solely for national citizens, other laws, such as bank secrecy, holding company laws, shipping laws, gambling laws and divorce laws have been largely created and maintained for the purpose of attracting an international clientele. Similarly, as will be discussed in Chapter 7, people and firms today have a wider discretion to pay taxes in the jurisdiction of their choice. As a result, countries which have higher taxes will lose at least some of their former taxpayers. This presents additional challenges to governments.

Section 1: Why Laws are Supplied

Laws are supplied for various reasons. The primary benefits of supplying liberal laws can be either direct or indirect. First, countries can get direct revenue from the additional fees or taxes that the use of a liberal law may provide. Additional economic activity directly derived from a liberal law provides an indirect or multiplier effect. The indirect benefits include the creation of a legal infrastructure which requires educated workers, such as lawyers, accountants, bankers and their staffs. This highly paid professional work adds substantial value and is environmentally friendly; it is exactly the kind of work that all nations desire. Because some companies will elect to maintain small offices there, real estate prices and land values should increase. Besides producing substantial taxes and fees, national revenue is augmented by increased income, property and employment taxes. There is also the possibility that more business trips would be made to the country. This will benefit the local tourism industry such as hotels, shops, taxis, restaurants and other services.³⁰⁷

Many countries supply laws in order to attract some of the quicksilver capital which is constantly circling the globe. If supply-side laws bring much needed capital and jobs to the jurisdiction, correspondingly, uncompetitive laws will tend to send at least some capital and employment away to more accommodating jurisdictions. The court, registration and filing fees help fund the legal system and the use of the laws provides work and employment to both lawyers and the rest of the legal infrastructure. Moreover this extra money and work mostly comes from sources who normally would not even think of doing any business in the jurisdiction; besides tourists who go to the beaches when there is relative political stability, who else is queuing up to go to Haiti and to do business there?

³⁰⁶ The attractiveness of bankruptcy laws is, however, assessed. *The World Competitiveness Report 1991*, Eleventh edition, (Lausanne: IMD, 1991).

³⁰⁷ The Bahamas are an excellent example of a country which has used supply-side laws to its advantage. In 1988, there were 380 licensed banks and trust companies in the country, compared with 300 in 1979. By the end of 1987, total deposits were \$170 billion and growing. The country's tax-haven status and strict banking secrecy laws have been fundamental in its banks' attraction of business. Moreover, it is easy for offshore institutions to establish a presence, once entry requirements are met. There are no statutory reserve or liquidity requirements and a minimum of regulation, and qualified banks can operate through a number of different vehicles. The Bahamas has developed a sophisticated infrastructure to support offshore operations. Leading international accountants, lawyers, investment advisers, and stockbrokers are represented in Nassau, and the country has excellent communications and computer facilities in addition to access to the SWIFT network for international payments. Not surprisingly the Bahamas are the richest country in the Caribbean. N. Peagam, "The Bahamas: Banking Moves into a New Era", *Euromoney Bahamas Supplement* (December 1987) pp. 7-12.

Section 2: Supply Side Law for Individuals

Supply-side law can generally be divided into laws for individual use and laws for firm use. Some supply-side law, such as bank secrecy law, is used by both firms and individuals.

There is an old saying that "you can't legislate morality." This saying is wrong: countries can and do legislate morality: most countries have at least some laws restricting abortion in at least some circumstances, the sale and use of alcohol and drugs, prostitution and gambling. Governments, however, cannot in most instances make it impossible for citizens to use the less restrictive laws of other countries, by prohibiting communication or travel to those countries.

Avoiding the consequences of local laws is more common than one might expect. Cross-border shopping, both physically and through the post (mail-order), is the most commonly used example of supply-side law. While differences in tax rates are the most common reason for cross-border shopping, they are not the only reason. More liberal operating hours for shops increase cross-border spending: longer hours and weekend shopping for shops and later closing hours and lower drinking ages for bars and night clubs bring customers to border areas.

One of the most unpleasant experiences that I ever had was linked to legislative morality and cross-border avoidance of local laws. In Finland, not only is alcohol heavily taxed, the sale of alcohol is prohibited on Sundays. At least as far back as 1982, the former Soviet Union was desperate to obtain hard currency, so it issued border visas for Finns, having good reason to suspect that the reason for the trip was to take advantage of the Soviet Union's alcohol laws. As a result, a large number of Finns planned Saturday road trips to Estonia in order to be able to drink both Saturday night and all day Sunday. On a Saturday night in Tallin the streets were inundated with staggering and vomiting Finns. Some were begging for money to pay for more drink. The next morning, the benches and part of the ground in the park, which was across from my hotel, were taken up by people who were either sleeping or passed out.

A. Abortion Laws

Abortion laws are another example of legislative morality. Certain jurisdictions either ban abortions entirely or make it very difficult to obtain one. Other jurisdictions permit abortions. This has been the source of at least some friction.³⁰⁸ So western Germans, Irish women and Americans from states with strict abortion laws often go to other countries and states (like China,³⁰⁹ Great Britain, east German Länder, the Netherlands,³¹⁰ Massachusetts or California) to terminate their pregnancy. The country or state which bans abortions can do little about it.³¹¹

³⁰⁸ One of the few major sticking points of German reunification was overcoming differences between the east's liberal abortion law and the west's restrictive one. The east received a transitional time when abortions were allowed. One of the most difficult negotiations involved stopping "Wessies" going east. K. Campbell, "A Break With the Past", *Financial Times Survey* (June 19, 1990) p. III/1. The differences in abortion laws have become a major source of contention, long after monetary, fiscal and social matters have been at least partially resolved. "Abortion Debate Splits Kohl's Forces", *International Herald Tribune* (September 17, 1991) p. 2.

³⁰⁹ China has the world's largest abortion market. About 25 million abortions are conducted annually. A. Rozeboom, "De Grootste Abortuskliniek ter Wereld", *Intermediair* (October 11, 1991) pp. 22-25

³¹⁰ M. van Look, "Abortus Provocatus, Juridische Status Quastionis en Perspectievels", *Tijdschrift voor Privaatrecht* (1974) pp. 419-472.

³¹¹ The European Court, reacting to a complaint from the Society for the Prevention of Unborn Children, tried to prevent Irish students from distributing information on how Irishwomen could obtain abortions abroad. The Court ruled that the Irish students are not permitted to distribute information since the students were acting as brokers for foreign abortion clinics. While the students were stopped, in the

Advances in medicine may make the debate over abortion almost moot. A group of French scientists have developed a pill that induces a miscarriage - this would make surgical abortions unnecessary. Even if governments try to ban the drug, there is no reason to expect that they will have any practical success in prohibiting its use. Unlike recreational drugs and steroids, which are almost universally condemned, yet still available, the so called 'abortion pill' would have support from at least a sizable minority of most populations, and a cross-border trade would almost certainly develop.³¹²

B. Gambling

Gambling is a huge and growing business. Various countries and American states have a large array of laws covering gambling. The total amount of money changing hands in legal and illegal gambling in 1989 in the United States was a staggering \$252 billion, an increase of 67% from 1982. The main reason for this explosive growth in gambling in America has been the proliferation of state-sponsored lotteries.³¹³ In Europe, about \$50 billion was legally bet in 1989. This makes gambling one of the world's biggest services, with the lowest costs and the highest level of profit potential. While demonstrating concern for the hardships which excessive gambling can produce, governments covet the large revenues which gambling can furnish. While many of the laws are geared toward nationals, there is still a large supply-side element (20% of all casino gamblers in EC countries are foreigners).³¹⁴

1. Europe

European gambling laws vary widely and attracts a large cross-border trade. Casinos are an interesting case in point. In France, for example, casinos were legalized in 1907, but only in resort cities (outside a 60 kilometre radius of Paris). Denmark is the latest country to legalize casino gambling, licensing its first casino in December, 1990. Denmark took this action to discourage gamblers from travelling to Germany and other places to bet. Currently, the only place where casinos are not found in Europe is in Ireland. While casinos are technically illegal in Belgium, they do exist and are policed by the Finance Ministry. In the Netherlands, all casinos are supposed to be state-owned, yet the state-owned casinos find themselves competing against illegal operations which are tolerated by the state.

Bingo is available in Spain, Portugal and the United Kingdom, but not elsewhere. The United Kingdom, with Europe's most extensive network of betting shops, is the only EC country not to have a lottery or toto (it does, however, have a huge football-pool). Horse racing is big business in France and the UK. The systems are run differently. In the UK, the betting shops are privately run; in France they are run by the state.³¹⁵ The French horse racing system attracts a large number of Italian, Belgian and German punters.

ruling, the Court ruled that abortions constituted a 'service.' This opens up the real possibility that European clinics will now be able to advertise their services in Ireland and the rest of the European Community, since a restriction of advertising would be in conflict with the concept of a Common Market. "Anti-Abortion Group Gets Mixed Victory in EC Court", *International Herald Tribune* (October 5, 1991) p. 2. A few months after this ruling, the Irish authorities initially blocked a 14 year-old Irish girl who was pregnant as a result of rape from going to England for an abortion. The Irish Supreme Court overturned a high-court injunction which barred her from travelling abroad. The case is a noteworthy demonstration of supply-side laws at work. J. Foote, "Ireland and Abortion: An Ethical Bind", *Newsweek* (March 16, 1992) p. 24.

³¹² J. Carey, "Can the 'Abortion Pill' Save Lives?" *Business Week* (December 17, 1990) pp. 56-58.

³¹³ D. Cordtz, "Betting the Country", 159 *Financial World* (February 20, 1990) pp. 22-26.

³¹⁴ M. Spain, "The Odds Against Harmony", 46 *International Management* (October 1991) pp. 89-91.

³¹⁵ The Pari-Mutuel Urbain has the third largest turnover of any French company. France has been accused by the British of subsidizing the shops. The EC is currently investigating. *Ibid*.

Germany, Ireland and Austria all run large lotteries which attract betters from other countries and advertise internationally. Spain has a private lottery run by and for the benefit of the blind. The foundation which runs the lottery has become one of the largest conglomerates in Spain. The countries with the biggest turnovers from lotto and toto - Germany (\$5.5 billion), Spain (\$5 billion) and France (\$3.5 billion) - also receive the most revenue. The amount paid to the winners varies amongst the various lottery games from a low of 29% in the British pools to 70% in the Netherlands. In 1993 a Eurolotto is scheduled to start.

Gaming machines, which have long been popular in Las Vegas and Monte Carlo, are a relatively new phenomena in Western Europe. They have become legal in Spain (since 1981), Germany (since 1985), the Netherlands (since 1986), France (since 1990) and Luxembourg (since 1990).³¹⁶

2. The United States

Traditionally the only state to have legalized gambling was Nevada. In the 1980s, many cities and states became desperate for additional revenues. Politically, legalizing gambling was often more attractive to politicians than raising taxes. In 1981, the state of New Jersey licensed casino gambling in Atlantic City. Atlantic City had over the years become a large slum. It was expected that gambling would bring punters from the New York, Philadelphia, Baltimore and Washington, D.C. areas and revitalize the old resort town. Initially, the casinos were like a licence to print money. Donald Trump was the largest owner of casino properties and was later listed as one of the richest men in the United States. Not surprisingly other areas wanted to grab a piece of the pie.³¹⁷ Iowa, North Dakota and Mississippi now have limited casino gambling.³¹⁸ Voters of Detroit and Miami, however, have rejected legalized gambling through referendums. It is still under consideration in Pennsylvania and Wyoming.³¹⁹ Some Indian reservations with their own jurisdiction became rich offering bingo. Lotteries are now operated in 28 states, and more are on the way. The popularity of state-run lotteries grew rapidly in the 1980s. Now lotteries are America's second largest form of gambling and are approaching the take of the Atlantic City and Nevada casinos. Total 1988 sales came to \$15.6 billion, with net income at 37% or about \$6 billion for state governments.³²⁰ In its first year, the Kentucky lottery brought in more than \$250 million in revenues. State lottery profits are typically equal to 40% of revenues.³²¹

C. Drug Laws

Supply-side drug laws can be divided into recreational drug laws and medicinal drug laws. Dutch recreational drug laws are not that different from the laws of other neighbouring countries: the major difference is that the possession of small quantities of "soft" drugs is tolerated. Selling drugs remains illegal and Dutch authorities tend not to enforce laws against selling small quantities of drugs. While the non-enforcement of the law is done primarily for domestic reasons, it has the added consequence of attracting drug tourists and addicts from across Europe.³²² Drug tourism was also the attraction of Nepal in the 1960s and 1970s. In addition to the Himalayas,

³¹⁶ Ibid.

³¹⁷ C. Welles, "America's Gambling Fever", *Business Week* (April 24, 1989) pp. 112-120.

³¹⁸ "American Survey: Rien Ne Va Plus", *The Economist* (December 15, 1990) at 23-24.

³¹⁹ K. Hannon, "Long Shot", *Forbes* (April 16, 1990) pp. 92-93.

³²⁰ J. Cook, "Lottomania", *Forbes* (March 6, 1989) pp. 92-96.

³²¹ E. Calonijs, "The Big Payoff from Lotteries", *Fortune* (March 25, 1991) pp. 109-114.

³²² For some interesting perspectives about Dutch drug laws see L.G.S. Wever, "Drugsbeleid; Paradoxaal en Een Dubbele Moraal", *Delikt en Delinkwent* (May 1986), pp. 436-440; R.M.A. Guldenmond, "Europa 1993 en het Beleid van Justitie", *NJCM Bulletin* (June 1989) pp. 414-424; L.A.R.J. de Beaufort, "Herionehandel bij Wijze van EC Delict", *Trema* (June 1982) pp. 125-127. Dutch drug policy may come under attack in a single European Market. See L. Raun, "The Netherlands", *Europe*

one of the main attractions of Nepal was the lack of drug laws. As a result hippies from across the world were drawn to Katmandu - perhaps to become as high as the neighbouring mountains.

Medicinal drug laws are enacted to prevent consumers from using untested, unsafe or ineffective drugs. Nevertheless, as indicated above when discussing the abortion pill, governmental (in)action does not keep individuals from wanting certain medicinal drugs which are unavailable in their country. The laws of other countries may be more accommodating. As a result, being a pharmacist or chemist in border towns like Tijuana, Mexico is a lucrative profession, since Mexican medicinal drug laws are decidedly more lax than American laws.³²³

D. Laws Involving Marriage

In some jurisdictions it is difficult or time consuming to get married; in others it is difficult to get divorced.³²⁴ In the Netherlands, for example, one must get an appointment with the local registrar in order to get married. The waiting list varies from city to city, but some people must wait up to two months. As a result some couples go to Belgium where marriage is easier. Dutch authorities will recognize the Belgian marriage certificate. Some American states, such as Nevada, have few requirements to get married. Others require going to the courthouse and getting blood tests. There is a street in Las Vegas where one can go 24 hours a day to get married - either by a preacher or by an Elvis impersonator who sings "Love Me Tender" exactly like the king. One of the reasons why the Nevada law is so liberal is that it attracts tourists to the state.³²⁵

Divorce is a little bit different. Traditionally, some jurisdictions have, for public policy or religious reasons, attempted to make divorce difficult.³²⁶ Luckily for some bickering couples, other countries, such as the Dominican Republic, Haiti, and Guyana have made getting a divorce easy. One only has to look in the classified section of international newspapers, like the International Herald Tribune, to find lawyers who advertise their services. As long as the parties can agree to a settlement, getting a divorce is easy. One needs only to fill in certain forms and wait two weeks by the mail box to receive a divorce which is recognized in most jurisdictions. Mail-order divorces are the type of supply-side law which are the focus of the rest of this chapter: laws which are almost entirely adopted in order to attract non-residents to use local laws and institutions.

E. Pension Trusts

International executives often have a problem with their pensions if they move from country to country. As pensions are normally, after one's home, the second most important asset of an international executive, they are matters of importance. Even as the 1992 programme nears completion, the European Community Member States have not been able to agree to common rules or tax provisions for multinational pension funding for persons who

(July/August 1990) pp. 34-38.

³²³ For an interesting article on the supply of medicinal drugs see A.M. Parkman, "Simultaneous Legal and Illegal Demand for Prescription Drugs", 17 Nebraska Journal of Economics and Business 21-30 (Summer 1978).

³²⁴ See i.e. J.M. Molto Damer, "Le Divorce en Droit International Privé Espagnol", N.T.I.R. (1974). pp. 171-182.

³²⁵ Along the same lines, Nevada is the only American state where prostitution is legal. Prostitution is far more regulated in Nevada than marriage is. For an interesting discussion over the advantages of legalized abortions see "Street Cleaning: AIDS has Strengthened the Case for Legalising Brothels", The Economist (September 7, 1991) pp. 50-51.

³²⁶ See R. Van Rooy, "Wetgeving Internationale Echtscheidingen", Ars Aequi (September 1981) pp. 420-429.

work outside the country where they are citizens.³²⁷ It is not always possible for expatriates to keep on contributing to their home countries' national pension programmes. One of the ways around this problem is for the expatriot to set up an offshore pension trust. Various locations have been developed to accomplish this. "The choice of ideal location for an offshore trust is frequently most influenced by national preferences. The Americans like Bermuda and the Caribbean; the British favour the Channel Islands; and the Germans, Luxembourg or Liechtenstein....[T]he Dutch invariably adopt Curacao."³²⁸ Over certain member states' objections, the European Commission has promised to supply law which will have onshore advantages which the offshore centres do not offer.³²⁹

F. Asset Protection Trusts

Doctors, accountants, lawyers, property investors, entrepreneurs and rich people contemplating marriage all have a common fear: a ruinous law suit. Many such people, especially in litigious America, are responding by protecting their money from patients, clients, creditors, spouses, tax collectors, lawyers and judges in asset protection trusts located in such unlikely places as the Cook Islands.

One of the reasons for professional people doing this is the way in which American tort law operates and insurance policies are written. Most insurance policies do not cover punitive damages, which in America are often several times the amount of actual and compensatory damages. Insurance rates for doctors are often so high that some operate without insurance cover. This too is risky as one claim could wipe out a doctor with substantial assets. Before asset protection trusts were developed, the choice of a doctor in this position was limited to transferring his wealth to his friend, relative or spouse. If a divorce or a 'misunderstanding' were to occur, custody of the assets would go to the spouse, relative or 'friend' as the assets were legally titled in their name.

An asset protection trust is generally constructed in the following manner. First a type of special limited partnership is formed; 99% of the partnership is owned by the offshore trust and the other 1% by the donor. The 1% partnership holding allows the donor to control the assets of the trust as if they were his (legally the assets are owned by the trust which is legally a separate entity apart from the donor). None of the assets are physically moved offshore. While all of the donees assets cannot be put into the trust, the only limitation on how much money and other assets can go into the trust is that the donor must remain solvent after the gift.

The trusts are relatively inexpensive to set up and maintain, costing \$15,000 to set up and \$1,000 per year to maintain (including legal fees). Asset protection trusts were first developed by a Denver, Colorado law firm and set up in the Isle of Man. Once this was done, other offshore financial centres, including the Bahamas and the Cayman Islands went into direct competition with the Isle of Man and queued up to offer asset protection trusts. The Cook Islands became the most friendly location of all - not surprisingly because the Denver law firm which

³²⁷ D. Harrison, "EC Blow to 'Mobile' Pensions", *Financial Times* (August 24, 1991) p. 10.

³²⁸ G. Clare, "Expatriates' Pensions and the Offshore Trust", *Watsons Eurocomment* (September 1991) pp. 13-14 at 14.

³²⁹ "The New Europension Directive", *Watsons Eurocomment* (September 1991) pp. 15-16. George Clare, who writes extensively on the subject, states that he will only believe that the benefits of a European onshore pension trust will exceed those benefits found offshore when the measure is passed and implemented. *Ibid.* at 13.

initiated the concept drafted the legislation.³³⁰ This has to be the ultimate supply-side law as it was created by and for the benefit of the law's best potential customer.

Section 3: Supply Side Laws for Firms

In addition to various types of supply-side laws for individuals, there are supply-side laws for firms. The types of laws provided can be grouped into those which facilitate transportation, financial services, financial markets and incorporations. This section will explain the importance of these laws for firms which operate in the international arena.

A. Internationally Mobile Assets - Transportation

Some supply-side laws are primarily enacted for the benefit of people who are constricted by the straight-jacket of national laws and would like to find a cheap and convenient alternative. As stated above, certain types of laws are primarily aimed at internationally mobile capital and international firms. Before the advent of telecommunications, the only objects which were both internationally mobile and which had no obvious nationality were ships.³³¹ It should then come as little surprise that international ship registration became the first type of global supply-side law. As early as the 16th Century, English owned ships sailed under the Spanish flag. Sailing under the Spanish flag brought fees to the Spanish Crown and allowed the English to profit from West Indies trade, where the Spanish maintained a monopoly.³³² The global nature of shipping brought about not only Liberian tankers³³³ and Greek³³⁴ and Panamanian ship registries, but an international shipping exchange where suppliers and customers of shipping services could meet: the Baltic Exchange is located in London. Recently, a futures market for shipping services has also been initiated in London. This market is already

³³⁰ The trusts have so far held up well to judicial scrutiny. The Denver law firm has defended 24 cases. All were settled out of court for about 15% of the original claim. It is contended that the trusts must be in existence for at least 5 years before the assets will be deemed fully out of the reach of creditors. Some contend that asset protection trusts are the ultimate pre-nuptial agreement - the assets never were part of the marriage, the putative spouse never has any direct access to the assets and a signature is not necessary for the pre-nuptial agreement to become valid. "Salting it Away", The Economist (October 5, 1991) p. 54.

³³¹ Unlike today where money moves through telephone wires, money (in the form of precious metals) was both expensive and dangerous to transport. Therefore it was not inherently highly mobile. Besides, money was not necessarily immediately acceptable. Foreign coins had to be weighed and checked for purity.

³³² Other notable past and present flags of convenience include: Greece, Panama, Liberia, Lebanon, Malta, Honduras, Cyprus, Somalia, Singapore, South Africa and the Channel Islands. For an interesting historical perspective of this phenomenon see B.A. Boczek, Flags of Convenience (Cambridge: Harvard University Press, 1962).

³³³ For an interesting article of how Liberia became a world shipping centre see R. Carlisle, "The 'American Century' Implemented: Stettinius and the Liberian Flag of Convenience", 54 Business History Review 175-91 (1980).

³³⁴ The Greek-owned fleet accounts for 14% of the world's total merchant tonnage - the largest single portion. J. Carr, "The Business Guide: Athens; Sea Lords", Business (May 1989) pp. 145-154 at 147. For an interesting discussion of how Greece became a worldwide shipping nation see M. Serafetinidis, "The Development of Greek Shipping Capital and Its Implications for the Political Economy of Greece", 5 Cambridge Journal of Economics 289-310 (1981).

accepted as the best and only indicator of future dry cargo freight rates.³³⁵ Besides ships, airplanes are increasingly flown under flags of convenience. If the trend continues and the importance of national flag carriers are diminished, a free trade in both airlines and air transport should eventually develop. In this instance, proportionally as many airplanes will fly under a flag of convenience as do ships sail.

1. Shipping Infrastructure

Supply-side shipping laws can be divided into supply-side backgrounds law (which include laws and procedures for chartering ships, insuring the ships and the cargo and a payment system, and shipping infrastructure) and ship registration laws. While there are a few large ships still registered under the British flag, London remains the major world centre of world shipping. It supplies everything that world shipping industry needs: a good worldwide communication infrastructure, efficient background laws, a court system which is competent and consistent, as stated above, it has an efficient market which coordinates the supply and demand for shipping services, and it has a competitive and efficient marine insurance market.³³⁶

2. Flags of Convenience

If a ship owner registers his ship in a country with favourable supply-side laws and the owner has no natural relationship with that country, it is said that the ship is registered under "a flag of convenience." Airplanes also can be, and often are, registered under flags of convenience. There are three basic reasons why flags of convenience are used: (1) to avoid taxation; (2) to minimize registration fees; and (3) to avoid labour and safety regulations. For currently registered ships, the market can be divided into two distinct sectors - the established flag sector and the flag of convenience sector. If a ship is "flagged-out," the vessel's registry is changed from its national flag to a flag of convenience. Through flagging out, the owners may be able to cut crew costs, management costs and tax liabilities while increasing labour quality.³³⁷ Some countries remain uncompetitive in shipping because of their domestic legislation. For example, existing maritime policies have played a role in preventing US flag vessel operators from adopting technology modern enough to make its fleet commercially competitive.³³⁸

The competition to provide these service is intense. In 1980, one-third of the world's tonnage was under European flags. Today only about 15% is. Different countries have responded in different ways to the availability

³³⁵ S. Laurie, "Trade Finance, Volatility Ahoy!" 139 *Banker* (June 1989) pp. 99-101. Futures markets have traditionally been either conducted on physical goods or financial instruments. The Baltic International Freight Futures Exchange marks the beginning of a futures market for services. Subsequently, in 1991, a financial futures market for real estate was established on the London Futures and Options Exchange (FOX). Also in 1991, the FOX merged with the Baltic Futures Exchange. Other contemplated (although not necessarily feasible) futures markets are those for: casualty insurance, air transportation, medical care, commercial advertising, data processing and child care. P.M. Johnson, "Next Growth Area: Futures on Services", 16 *Futures: The Magazine of Commodities & Options* (June 1987) pp. 12-14. Amid problems and scandals, the financial futures market for real estate was soon suspended because of allegations of financial improprieties. It is unclear whether the market will reopen in the future. See D. Barchard, "Statement Expected on Resignation from FOX", *Financial Times* (October 7, 1991) p. 17; R. Waters, "FOX Gave Brokers Indemnities", *Financial Times* (October 8, 1991) p. 21; "Trading Inquiry Clouds London Futures Market", *International Herald Tribune* (October 9, 1991) p. 11.

³³⁶ See Lord Chorley of Kendal and C.T. Bailhache, *British Shipping Laws: The Law of Marine Insurance and Average* (London: Stevens & Sons, 1961).

³³⁷ Labour quality may alter because some countries require the use of a crew with local citizenship. See G.N. Yannopoulos, "The Economics of 'Flagging Out'", 22 *Journal of Transport Economics & Policy* 197-207 (1988).

³³⁸ C.B. Donn, "Foreign Competition, Technological Change, and the Decline in U.S. Maritime Employment", 27 *Transportation Journal* 31-41 (Summer 1988).

of flags of convenience. In 1991, Luxembourg, which is over 250 kilometres from the nearest coast, began its assault against other flags of convenience. It did this to preempt the European Community's attempt at the creation of a single European flag. Like its competitors, Luxembourg ships will pay minimal taxes. Unlike some other flags of convenience, the Luxembourg law requires the payment of a minimum wage to sailors. Luxembourg hopes to diversify its economy and to make money from registering the ships.³³⁹ Meanwhile, Malta has decided to become a full-fledged supplier of flags of convenience and as a result, the island ranks as an increasingly important locale for ship registration. Additionally, in 1988, Malta's government enacted legislation to turn Malta into an offshore centre.³⁴⁰ Norway, on the other hand, has decided to try to differentiate its product. In 1987 the government established the Norwegian International Shipping Register, which provided a Norwegian alternative to low-cost ship registers and a framework for revival. As a result, more than 90% of Norway's shipping services are exported. This means that most 'Norwegian' merchant vessels handle cross-trading for foreign customers worldwide.³⁴¹

B. Financial Services

As money becomes more mobile and its origin cannot be traced, certain countries have set themselves up to attract international investors by providing laws which facilitate financial service. The types of financial services which are offered include offshore banking, bank secrecy,³⁴² and insurance services. Pension and trust services have already been discussed; these are other types of financial services.

An increasing number of islands, mini-states, and developing countries are promoting themselves as providers of financial services. Nowhere is the competition more intense or the field more crowded than in the Caribbean and in the English offshore islands. Together these offshore financial centres have garnered a substantial slice of the global, multi-billion dollar, financial services business. The only reason why these sleepy outposts have been able to become relative financial services giants is that they have enacted favourable supply-side laws which can be used to break free of restrictive and slowly developing national ones.

1. Offshore Banking

Various countries, including Guernsey and the Isle of Man, which are established offshore centres, have long promoted their managed banks that require no physical presence.³⁴³ The various Caribbean offshore banks have bank deposits totalling well over \$600 billion. The Caribbean is so attractive because of its proximity to the US, its location between the US and Latin America, and the fact that the inhabitants speak English.³⁴⁴

Some think that specialization may be emerging in different centres, along with stratification, as the more developed centres become increasingly selective. Centres are revising regulations, introducing greater supervision, and seeking to upgrade their image. Also, banks throughout the region have tightened their rules on accepting cash deposits from strangers. With the fall of the Bank of Credit and Commerce International, which was registered in the Grand Cayman Islands and Luxembourg and headquartered in London, worldwide bank

³³⁹ "The Old Red, White and Blue", The Economist (January 12, 1991) p. 70.

³⁴⁰ P. Singleton and B. Davies, "Malta: Sailing into the Grand Harbour", Euromoney Supplement (December 1988) p. 23.

³⁴¹ D. Rudnick, "Norway: Shipping Steams Ahead", Euromoney Norway Supplement (June 1990) pp. 23-25.

³⁴² Offshore banks exist because they provide bank secrecy.

³⁴³ L. Holstrom, "Offshore Centres: The Name of the Game Is Tax Efficiency", Euromoney Supplement (December 1988) pp. 2-4.

³⁴⁴ N. Peagam, "Nine Centres Worth Finding on the Map", Euromoney Treasure Islands Supplement (May 1989) pp. 4-12.

regulators have found virtually non-existent bank regulation to be a complete failure, both economically and politically. As a result, it is doubtful that operating a bank which is licensed offshore will be permitted in very many countries in the future.

2. Bank Secrecy

Governments have varying degrees of authority to learn about the financial affairs of the clients of local banks and their customers. Since certain firms and individuals prefer higher levels of bank discretion, different countries have enacted higher standard bank secrecy laws in order to attract an international clientele. The traditional role model of supply-side bank secrecy law was Switzerland.

In 1934, Switzerland passed its first federal bank secrecy law. Not surprisingly its first major group of customers were German Jews attempting to shield their wealth and property from the Nazis.³⁴⁵ Banking became a big industry in Switzerland; banking accounts for 4% of Swiss Gross National Product.³⁴⁶ There is now a trend against bank secrecy in Switzerland.³⁴⁷ Complete banking secrecy was maintained in Switzerland until 1990, when a law against money laundering was passed.³⁴⁸ Bank secrecy came under further scrutiny in 1991 when, in order to further fight money laundering, another element of bank secrecy was eliminated: the ability of a lawyer to open an account for a client without divulging his name.³⁴⁹

The Swiss have lost clients for their supply-side law over time because they did not adjust their policies in a period when competitors were springing up throughout the world. Luxembourg and other offshore centres have jumped into the breach and prospered. In the early 1970s, Swiss investors, considering the 35% withholding tax levied on interest from Swiss accounts excessive, transferred their private money to Luxembourg, which levied no withholding taxes. The big 3 Swiss banks, United Bank of Switzerland, Credit Suisse, and Swiss Banking Corporation, reacted by setting up Luxembourg subsidiaries to manage their clients' money.³⁵⁰ In 1981, in order to expand upon the three Swiss banks' activities, Luxembourg passed a bank secrecy law. Because of these two supply-side laws, bank secrecy and no withholding tax, banking became the nation's main money-maker within seven years. Today, Luxembourg is said to be the smaller investor's Switzerland. It specializes in investors with between \$500,000 and \$2 million. Its fees are much lower than those of Swiss banks.³⁵¹ From 1986 to 1988, there was a dramatic 50% annual increase in investment capital inflows to Luxembourg. Not surprisingly, an influx of foreign banks soon followed. The benefits of this strategy for Luxembourg can be seen in the following statistics. The environmentally friendly and highly paid banking industry has replaced steel and agriculture as Luxembourg's main industry and accounts for 15% of the total gross national product, 20% of government revenues,³⁵² and employs almost 10% of Luxembourg's total workforce.³⁵³ Obviously

³⁴⁵ P.W. Bartelings, "Het Bankgeheim Staat of Valt Bij de Wet; Enkele Opmerkingen over het Bankgeheim in Nederland, Zwitserland en Luxemburg", TVVS (March 1991) pp. 57-62 at 60-61.

³⁴⁶ "Private Banking Survey", Economist Survey (June 24, 1989) p. 25.

³⁴⁷ J. Carr, "The Discreet Charm of the Swiss Lawyer", 5 International Financial Law Review 7-10 (November 1986).

³⁴⁸ W. Dullforce, "Squalls in a Safe Haven", Financial Times (December 13, 1990) p. III/1.

³⁴⁹ These accounts were known as "formula B" accounts. W. Dullforce, "Critics See Ambiguity over Client Privacy", Financial Times (December 13, 1990) p. III/7.

³⁵⁰ G. Humphreys, "Luxembourg: Bigger Fish in a Smaller Pond", Eurumoney (July 1987) pp. 83-92.

³⁵¹ "Spotlight on Luxembourg: The Little Switzerland with a Different Philosophy", 12 Asian Finance (August 1986) pp. 79-82; D. Benn, "Luxembourg's Star Role", The International (June 1991) pp. 45-48.

³⁵² D. Holden, "The Grand Duchy Makes a Comeback", 99 United States Banker (April 1988) p. 61.

growth could not continue forever. By 1991, 185 banks were operating in Luxembourg, up from 122 banks in 1986. Not surprisingly, staff costs have grown and profitability in the banking industry has decreased over the last two years.³⁵⁴

Liechtenstein also decided to compete with Switzerland head on. It enjoys a common customs and monetary union with Switzerland, but the two countries' taxation laws differ. Liechtenstein has lower taxes, and its financial institutions are still forbidden by law to disclose any information in connection with tax offenses that breach foreign laws. Foreign funds account for more than 70% of all deposits in the country's three banks.³⁵⁵

In the future, Luxembourg (and to a lesser extent Liechtenstein) will face increasing competition from an emergent united Germany and a greater Europe. Luxembourg has the difficult task of overcoming its reputation as a haven for tax cheats and money launderers. The grand duchy's banks want to prove that, while secrecy is essential, it is not an absolute principle. In the past, Luxembourg has proved adept at changing with the times and has become attractive for reasons other than low taxes and secrecy. In order to remain competitive, some further changes are needed, such as the redrafting of outdated legislation covering supervision of the stock exchange.³⁵⁶

One can compare the bank secrecy policies of Switzerland, Liechtenstein and Luxembourg with other Western European countries which have adopted different approaches toward secrecy. The United Kingdom law waives bank secrecy whenever there is a court order, there is a public duty, it is in the interest of the bank, or the client gives permission. France permits the dissemination of information to legal and bank supervisory authorities, when the client consents. In Finland, information may be provided to legal and police authorities investigating a crime and to tax authorities. Belgium and the Netherlands do not recognize banking secrecy apart from the terms of the contract. In Italy, banking secrecy may be implied from various other laws. Most of the countries recognize only civil liability, but criminal sanctions may be imposed in Luxembourg, Norway, Finland, and Switzerland.³⁵⁷ Monaco also has a high level of banking secrecy and other favourable fiscal incentives for banking.³⁵⁸

3. Insurance

While London has long been and remains the leading insurance centre in Europe, it has been under strong competitive pressure from other countries. For example, in 1990, Luxembourg had 113 captive reinsurance brokers, up from 100 in 1989.³⁵⁹ During the same period, gross premiums in Luxembourg rose 133% to about \$2 billion. Ireland has over the past few years made an aggressive attempt to make Dublin a worldwide financial centre. It has the European Commission's approval to charge a 10% corporate tax rate for insurance and

³⁵³ E.A. Finn, Jr. and T. Pouschine, "Luxembourg: Color It Green", 139 *Forbes* (April 20, 1987) pp. 42-45.

³⁵⁴ "Not so Grand in the Duchy", *The Economist* (August 31, 1991) pp. 72-73; A. Hill "Is the Golden Age Over?" *Financial Times* (October 2, 1991) p. 27.

³⁵⁵ J. Arbose, "The Bulging Coffers of Liechtenstein's Secretive Banks", 42 *International Management* 28-30 (February 1987).

³⁵⁶ M. Blanden, "Luxembourg: Nimble Footwork Needed", 140 *Banker* (September 1990) pp. 20-22.

³⁵⁷ T. Salminen, "Banking Secrecy Legislation in Western Europe", 11 *Issues in Bank Regulation* 30-32 (Spring 1988).

³⁵⁸ P. Singleton and B. Davies, "Monaco: For Cash, the Cache with Cachet", *Euromoney Supplement* (December 1988) pp. 26-28.

³⁵⁹ Reinsurance is the insurers' way to share out risks. Reinsurance occurs when the primary insurer (or underwriter) pays other insurers to take all or part of their risk. R. Pennant-Rea and B. Emmott, *Pocket Economist*, Second Edition (London: Basil Blackwell, 1983) p. 200.

most other types of financial service companies. Luxembourg is currently introducing a change in its insurance tax system in response.³⁶⁰ Swiss insurers manage about \$180 billion in assets. About 60% of their premiums come from abroad.³⁶¹ The Dutch are one of the largest users of offshore reinsurance companies.³⁶² Competitive pressure on countries to pass supply-side insurance laws is almost certain to continue in the future.³⁶³

Roughly half of all the world's captive insurance companies are in the Caribbean, the largest host country being Barbados. Singapore and Guernsey have recently made active attempts to become regional insurance centres. Singapore began licensing captives in 1983 with some success. Singapore hopes to become an Asian centre for insurance and reinsurance and a domicile for captive insurance companies.³⁶⁴ Guernsey, one of the Channel Islands, is the largest offshore captive insurance haven in Europe. Its 63,400 residents enjoy virtually full employment. About 50 banks are represented there, and 200 captive insurance companies are domiciled in Guernsey. It offers advantages such as close proximity to London insurance markets, modestly priced accommodation, stability, and a well-developed infrastructure. However, there are some disadvantages to doing business in Guernsey. For example, it can get fogged in, preventing airplanes from arriving and departing, there is a critical staff shortage adversely affecting many businesses, and companies allowed to operate there must demonstrate they can contribute to the island's revenue. Although some believe that a 20% tax on insurers' profits is a disadvantage, others say the tax laws could be a drawing card now that the British corporate tax rate has been lowered to 33%.³⁶⁵

Barbados was so successful as an insurance centre that, in 1989, the United States cancelled a foreign exchange tax concession that was a major pillar of Barbados' fledgling offshore finance industry. Barbados' success stemmed from two agreements it made with the United States in the mid-1980s, a tax information agreement and a double tax treaty, which overrode domestic bank secrecy laws and allowed the American Internal Revenue Service to obtain taxpayer information from Barbados, including bank records and other confidential documents, regardless of the subject's nationality. In return, the United States declared Barbados a tax-deductible site for conventions and made it eligible to receive funds from Puerto Rico. The United States also approved Barbados as an offshore domicile for sales corporations and declared the premiums paid from the United States to insurance companies on the island exempt from American federal excise tax. Barbados' main attraction has been its double tax treaties with the United States, Canada, Germany and the United Kingdom. At present, other insurance centres in the region hope to benefit from an exodus of captive insurance companies from Barbados.³⁶⁶

The Cayman Islands are the second most popular captive insurance domicile in the world, with 17% of the world's 2,300 captive insurance companies established there. In recent years, the Grand Caymans have suffered a slow-down in the formation of new captives, due to: (1) a slow down in the insurance market which has

³⁶⁰ S. Shapiro, "Luxembourg Captive Growth Continues", 24 Business Insurance (April 30, 1990) pp. 84-85.

³⁶¹ W. Dullforce, "Turning Point as Tax Haven Loses Charms", Financial Times (June 10, 1991) p. III/4.

³⁶² "Approaching the Single Market", 4 ReActions 28-30 (April 1988).

³⁶³ A.M. Baker, "Liberalization of Trade in Services--The World Insurance Industry", in O. Giarini (ed.), The Emerging Service Economy (Oxford and New York: Pergamon Press, 1987) pp. 193-211.

³⁶⁴ K.J. McIntyre, "Singapore Aiming to Be Insurance Centre", 20 Business Insurance (November 24, 1986) pp. 63-64.

³⁶⁵ S. Shapiro, "Guernsey Touts Its Advantages for Captives", 20 Business Insurance (October 20, 1986) p. 108. The article contends that Guernsey surpasses all offshore domiciles, including Bermuda and Gibraltar, for cost and efficiency.

³⁶⁶ N. Peagam, "The US Hits Barbados as a Captive Insurance Centre", Euromoney Treasure Islands Supplement (May 1989) pp. 31-34.

lessened the need for alternative insurance mechanisms; (2) increased competition from offshore domiciles, such as Bermuda, and onshore American domiciles, particularly Vermont, have been encouraged by favorable state regulations; and (3) favorable tax treaties that Barbados and Bermuda have had with the United States. Many of the insurance policies written by Cayman Islands insurance companies are for liability coverage, including products liability and medical malpractice. The expertise and experience already developed in the medical malpractice field in Cayman is unsurpassed. Some of the positive characteristics of the island include political stability, good communications, a nonbureaucratic environment, and reasonable solvency; all attributes of an efficient market.³⁶⁷

C. Financial Markets

Most of the world's capital markets started out serving one big borrower: the government. Today's capital markets have transcended far beyond such mundane origins. New securities and financial instruments are constantly being developed. Even though the importance of government debt has diminished, government debt issues remain the world's most abundant tradable securities. They provide the benchmark for other interest rates, as well as for futures and options on many commodities, including money.³⁶⁸ Since at least the 16th Century, governments have solicited funds from international investors. Since governments have an incentive to pay the lowest interest rate possible, not all government debt has historically been traded on national capital markets.³⁶⁹ While most capitalistic countries have capital markets,³⁷⁰ certain financial centres have become more successful than others.

Most financial exchanges were similar until large mainframe computers began being used in the 1960s to store information on the institution's accounts. The first computer dealing system began in London. With the system, merchant banking and insurance organizations advised each other of securities they wished to buy or sell and agreed on a price. The internationalization of the markets and 24-hour trading has had three results: (1) securities markets have become increasingly similar in structure and methods of working; (2) trading floors have become largely obsolete; and (3) banks and large securities houses have become the main brokers and dealers.³⁷¹

Not all financial markets have kept pace and therefore are not created equal. The success of any financial market will be judged on three factors: transparency,³⁷² liquidity,³⁷³ and costs.³⁷⁴ Some countries have shot

³⁶⁷ P. Samson, "Conducting a Cayman Captive: Features of Cayman". 1 *ReActions* 25-27 (August 1990).

³⁶⁸ "The World Bond Bazaar", *The Economist* (September 21, 1991) p. 97.

³⁶⁹ P. Kennedy, *The Rise and Fall of the Great Powers* (New York Random House, 1987) pp. 76-86. For an interesting overview of the emergence and development of an international financial market see J.C. Riley, *International Government Finance and the Amsterdam Capital Market 1740-1815* (Cambridge: Cambridge University Press, 1980).

³⁷⁰ Even third-world countries are opening up to competition on this front. See S.E. Katz, "Financial Service: A Rare GATT Success", *Wall Street Journal Europe* (October 11, 1991) p. 8.

³⁷¹ J. Revell, "Technology and Capital Markets", 7 *World of Banking* 14-19 (March/April 1988).

³⁷² Frankfurt, New York, London, Paris and Tokyo have all recently had financial scandals. The difference is that New York, London and to a slightly lesser degree Paris are seen to be fundamentally open and honest; Tokyo and Frankfurt are not. "German Insider Trading: Behind the Times," *The Economist* (July 13, 1991) p. 86. S.M. Lukow, "Survey Reveals Outsiders' Doubts about Tokyo Stock Exchange, 58 *Tokyo Business Today* 50-51 (March 1990). This survey was taken before a series of financial scandals rocked Japan, lowering confidence further. See "The Rot in Japan," *The Economist* (July 13, 1991) p. 17-18. France also has its problems. See J. Sasseen, "Can Paris Clean Up the Bourse?" 44 *International Management* 16-22 (January 1989).

themselves in the foot by passing laws which raise costs³⁷⁵ - or alternatively by having insufficient regulation which has the effect of lowering transparency.

A trend toward financial deregulation began in 1975 when the United States abolished the payment of fixed commissions to brokers for securities transactions. This change, coupled with the increased use of computers fundamentally changed Wall Street by forcing brokerage firms to become competitive.³⁷⁶ Eleven years later, Great Britain did much the same thing and began to actively compete with Wall Street.³⁷⁷ The reforms were called the "Big Bang." The purpose behind the changes was to give London the opportunity to compete with New York and Tokyo on equal terms in the increasingly 24-hour-a-day global trading.³⁷⁸ The Big Bang brought growth and development for international futures and options exchanges. London expanded its market share and product line by introducing, for example, Japanese bond futures, Paris, Amsterdam, Zurich, Barcelona, Stockholm, Toronto, Singapore, Hong Kong, Sydney, Auckland, and Sao Paulo (now the world's biggest option exchange) all became international competitors.³⁷⁹ The competition is fierce and getting fiercer.³⁸⁰ In 1992,

³⁷³ In 1991, the Milan bourse, after a stock scandal, was beset by labour problems. Reform is on the agenda for January 1, 1992. These problems led to a lack of liquidity when volumes more than halved. G. Collins, "Milan Traders Set to Strike Over Reforms", Wall Street Journal Europe (October 11, 1991) p. 11. As part of the reforms all share trading has to be done through the bourse; before banks often matched buy and sell orders. This further reduced liquidity and transparency in the market.

³⁷⁴ Securities transactions, in theory, can be costly. These costs are a combination of commissions, taxes, and market impact. In the 1990s, the control of costs will become increasingly important. C. Sinclair-Poulton, "Cutting Pension Fund Costs - A Direct Approach", 19 Benefits & Compensation International 11-13 (March 1990).

³⁷⁵ Regulated commissions, stamp or turnover taxes and non-screen based trading are all examples of measures which raise costs.

³⁷⁶ B. de Caires (ed.), The GT Guide to World Equity Markets 1987, (London: Euromoney, 1987) p. 500.

³⁷⁷ G. Platt, "Big Board and Big Bang", 4 InterMarket 7-12 (February 1987). The ways in which Great Britain seeks to compete with America are interesting. In the UK, the freedom from exchange controls and the tax advantages that exist for those domiciled abroad have attracted rich foreigners in search of ways to protect their money from the political turbulence of their native lands. These supply-side laws have attracted a large number of rich Indians, Iranians, Lebanese, Greeks, Iraqis, Egyptians, Sudanese, and other Africans. One great advantage the UK has over the US is the taxation rules, which are based on domicile. An individual who has a non-UK domicile status can be resident in the UK without paying UK tax on non-UK income and capital gains unless they are transferred to the UK. The trick for these people is to keep their assets offshore, perhaps in the Channel Islands, then only bring the capital into the UK and use that to provide living expenses. Such capital escapes tax as long as these residents do not bring in income from abroad. M. Bose, "The Inscrutables: Foreign Financiers in the UK", 42 Director 54-57 (May 1989).

³⁷⁸ On October 27, 1986, the UK securities industry introduced a series of rule changes commonly referred to as the 'Big Bang.' Elements of the Big Bang included: (1) the elimination of the schedule of minimum commissions for each type and size of trade; (2) the removal of distinctions between stockbrokers and jobbers; (3) permission for companies outside the stock exchange to become corporate members, and (4) the introduction of SEAQ, a quote system based on the US National Association of Securities Dealers' automated quotation service, to which SEAQ will be linked by satellite. W. Kay, "Thunder on Throgmorton Street: The Big Bang Will Bring Explosive Change to the City", Barron's (September 29, 1986) pp. 13, 44-47.

³⁷⁹ K. Pierog, J. Stewart, S. Schoenfeld and R. Alpe, "International Trading Scene Booming", Futures: The Magazine of Commodities & Options (September 1987) pp. 56-59, 88.

Brussels, Milan, Helsinki and Vienna were set to become new competitors.³⁸¹ Not surprisingly London, by taking the most dramatic liberalization measures, started to take a significant amount of business away from other European exchanges.³⁸² The European exchanges soon after began to reform by having their own 'bangs' with different levels of noise.³⁸³ Changes may be too late. Responses to these changes will be discussed in Chapter 8.

D. Dispute Resolution

The massive expansion of global contacts in the 20th Century has required the creation of dispute resolution mechanisms for international business conflicts. The three most important international conventions on international dispute resolution are the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, The Hague Convention of Service Abroad of Judicial and Extrajudicial Documents, and the Hague Convention on the Taking of Evidence Abroad in Civil and Commercial Matters.³⁸⁴ In addition, these conventions compete with the International Chamber of Commerce's Rules on Arbitration.³⁸⁵

Since parties have some latitude to do a certain amount of forum shopping, not surprisingly governments are competing to offer the site for the arbitration hearings.³⁸⁶ The countries must compete on three bases: transparency, consistency of rulings, and costs. While arbitration institutions are found in many countries, there are four major institutions: (1) the International Chamber of Commerce in Paris; (2) the American Arbitration Association in New York; (3) the World Bank in Washington; and (4) the London Court of International Arbitration.³⁸⁷ Other lesser international competitors include the Stockholm and Geneva Chambers of Commerce.³⁸⁸ The International Chamber of Commerce's Court of Arbitration in Paris is still the largest tribunal, hearing about 350 cases annually.³⁸⁹ London, which had established a private arbitration institution, the London Court of Arbitration, as far back as 1892,³⁹⁰ again became a major competitor when the British government passed the UK Arbitration Act of 1979 and the London Court of Arbitration issued its New

³⁸⁰ "Matif Is Braced for New Competition", Wall Street Journal Europe (October 7, 1991) p. 11.

³⁸¹ "European Futures and Options: Derivative Diplomacy", The Economist (September 21, 1991) pp. 98-99.

³⁸² See generally, I. Walter, Global Competition in Financial Services: Market Structure, Protection, and Trade Liberalization (Cambridge, MA: Ballinger, 1988).

³⁸³ "European Capital Markets -- After the Big Bang, a Whole New Ball Game in the City", 12 Asian Finance (September 15, 1986) pp. 102-104.

³⁸⁴ S.R. Swanson, "Comity, International Dispute Resolution Agreements, and the Supreme Court", 21 Law & Policy in International Business 333-365 (1990) at 335.

³⁸⁵ C.R. Seppala and D. Gogek, "Multi-Party Arbitration Under ICC Rules", 8 International Financial Law Review 32-34 (November, 1989).

³⁸⁶ M. Bishop and G. Carne, "EC Suffering From Ignorance of Market for Legal Services", Financial Times (November 5, 1990) p. 16.

³⁸⁷ For an interesting article on the competitive process of nations with regard to arbitration see M. Rowe, "Arbitration - Getting the Best Deal", 7 International Financial Law Review 26-31 (March 1988).

³⁸⁸ R. Folsom, M.W. Gordon and J.A. Spanogle, Jr., International Business Transactions, Second Edition (St. Paul: West Publishing, 1988) p. 467.

³⁸⁹ B. Thompson, "Resolving Business Conflict", 95 Canadian Banker 42-46 (May/June 1988) at 44.

³⁹⁰ Supra note 85 at 461.

Arbitration Rules in 1981. The courts have subsequently ruled that court costs are to be waived if the decision of the arbitration is brought to the U.K. courts.³⁹¹

E. Holding Companies

Holding companies are used for two reasons. First, a company has an identity separate from its shareholders. Second, since shareholders and companies are usually taxed in different ways, opportunities for tax planning develop. In most countries the tax rates on companies and individuals vary. If individual taxation is high and an investment is placed in a low tax country the investor has a large incentive to delay dividend payments or repatriating profits. The holding company creates possibilities for legitimate tax minimization - both in terms of deferral and in terms of tax avoidance. Offshore areas with their low taxes, tax exemptions and in some cases zero tax status, have a vital role in international tax avoidance. A growing number of countries and territories have made themselves available for the setting up of various types of holding companies and offshore trusts. These include: Andorra, Anguilla, Antigua, Bahamas, Bahrain, Barbados, Bermuda, the British Virgin Islands, Campione, Channel Islands, the Cook Islands, Cyprus, Gibraltar, The Grand Cayman Islands, Hong Kong, Ireland, the Isle of Man, Liberia, Liechtenstein, Luxembourg, Madeira, Malta, Monaco, the Netherlands, the Dutch Antilles, Nevis, Panama, Switzerland,³⁹² the Turks and Caicos Islands, the United Kingdom, the United States (in the state of Delaware) and Uruguay.

International groups have increasingly made use of holding companies established in foreign countries in order to optimize the tax costs of the group. This goal is principally achieved by using the holding company to reduce foreign withholding taxes on capital flows from operating subsidiaries abroad to the parent company and to equalize the income of subsidiaries established in the same country.³⁹³

F. Company Law

As will be seen in the next chapter, the trend throughout the world is to tax capital less and less. This is at least partially in response to the advent of quicksilver capital and partly because of the laws of the 32 jurisdictions listed above, which supply law which offers the opportunity to minimize or avoid taxation. In the remainder of this chapter, company law as a supply side law shall be discussed. As discussed at the end of the previous chapter, as firms carry out their operations on an increasingly international scale, the 'nationality' of many companies becomes more and more unclear. This fact, taken in conjunction with lower and lower capital taxation and higher and higher incentives to attract inward investment, will lead to a blurring of the distinction between holding companies and incorporations; firms will incorporate in countries which offer them an optimal combination of low tax and low regulation. This place will, in short, be the country which supplies them with the most efficient law.

³⁹¹ A.L. Marriott, "Arbitrating International Commercial Disputes in the United Kingdom", 44 Arbitration Journal 3-13 (September 1989).

³⁹² The countries listed have been compiled from brochures of various commercial enterprises who sell off-the-shelf pre-registered companies and other tax advice. These companies regularly advertise in the classified sections of international newspapers and financial and business magazines. One company, OCRA, whose business address is a post office box in the Isle of Man, states that they act "for a wide range of clients from large multinational companies to family businessmen to private individuals. OCRA's clients are engaged in their own country or internationally in many areas of activity such as: The Arts, Agriculture, Banking, Brokerage, Chemicals, Construction, Distribution, Electronics, Exporting, Energy, Engineering, Fund management, Film Production, Hotels, Importing, Insurance, Investment Advice, Manufacturing, Natural Resources, Oil and Gas, The Professions, Property, Project Financing, Retailing, Shipping, Show Business, Textiles, Trading, Unit Trusts." Also mentioned in this brochure are Patents, Technical Know-How Licences, Franchises, Factoring and Confidential Invoice Discounting.

³⁹³ K. Simon, "Foreign Holding Companies and the Luxembourg Rule: Sweden", 44 Bulletin for International Fiscal Documentation 395-99 (August/September 1990).

In Europe (and the rest of the world), it is not inconceivable that one country will completely eliminate profits tax and liberalize its company laws solely to attract the chartering fees and other benefits³⁹⁴ which could be derived from attracting European incorporations.³⁹⁵ Other than for sentimental or historical reasons there is no reason for companies to retain their perceived present national identities. Today a large portion of many companies' operations, sales and perhaps more important, their shareholders lie outside of the national boundaries of many companies' countries of incorporation. There is an old saying that money holds no emotions. It is unlikely that shareholders will allow a company to offer them less control over management, pay more taxes and incur greater expenses than it needs to forever. This will be the focus of Chapter 8.

Section 4: Conclusion

Change is in the wind. In search of efficient law and efficient outcomes, a great deal of paper shuffling and travel has and will continue to take place in the future. Moreover, there is little that governments can do about using supply-side laws, short of unanimous harmonization. The purpose of this chapter was to illustrate some of the areas in which countries have competed against each other in order to create jobs and attract revenue. In doing so, certain countries have created more efficient law for many cross-border users. While the purpose of using many of the above mentioned supply-side laws is to minimize or avoid taxation, the primary purpose for supplying these laws is in order to create employment and to collect licensing fees and indirect tax revenues.

This chapter concludes with a caveat: nationally efficient law and internationally efficient law are different. In some cases there is a trade-off. Competition for liberality cannot be a good thing if industry is under-regulated to the extent that minimum social standards are abrogated,³⁹⁶ fraud can be pervasive or that resources are underpriced. The BCCI scandal demonstrates that liberality can be used to undermine legitimate national authority.³⁹⁷ Minimal social standards and asset underpricing occurred in the 1970s, when Mexico, Romania

³⁹⁴ As indicated above, the other benefits which accrue to the country with the most liberal company laws include increasing the size of its capital market and the amount of employment for educated workers such as lawyers, accountants, investment bankers and their staffs. Because some companies will elect to maintain small offices there, real estate prices would increase. Besides producing substantial chartering fees, national revenues would be augmented by increased income, property and employment taxes. Finally, there is also the possibility that the number of shareholders' meetings and business trips would increase. This would increase the revenue and employment associated with the travel industry.

³⁹⁵ It should be clearly understood that when discussing attracting corporate charters, this is not meant to imply that any manufacturing or management jobs would necessarily move in the process of changing the company's country of incorporation.

³⁹⁶ Some concerns in the area of lax company law come from W.L. Carey, "Federalism and Corporate Law: Reflections on Delaware", 88 Yale Law Journal 663-682 (1974); D. Schwartz, "A Case for Federal Chartering of Corporations", 31 Business Lawyer 1125-1138 (1976); K.E. Scott, "The Dual Banking System: A Model of Competition in Regulation", 30 Stanford Law Review 1-24 (1977); R.K. Winter, Jr. "State Law, Shareholder Protection, and the Theory of the Corporation", 6 Journal of Legal Studies 251-292 (1977); and P. Dodd and R. Leftwich, "The Market for Corporate Charters: 'Unhealthy Competition' vs. 'Federal Regulation,'" 53 Journal of Business 266-283 (1980). Some praise for competition in corporate regulation comes from S. Fischel, "The 'Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law", 76 Northwestern University Law Review 913-934 (1982); B.D. Baysinger and H.N. Butler, "Race to the Bottom" vs. "Climb to the Top": The ALI Project and Uniformity in Corporate Law", 10 Journal of Corporation Law 431-462 (1985); and R. Romano, "The State Competition Debate in Corporate Law", 8 Cardozo Law Review 709-757 (1985).

³⁹⁷ This has led to an international concern for financial regulation. "Group of Seven Stress Need To Combat Recent Scandals in World Financial Markets", International Herald Tribune (October 14, 1991) p. 1.

and some African countries supplied environmental regulations in order to attract pollution creating industries.³⁹⁸ These types of law, however "liberal," cannot be called efficient since they do not lower long-term transaction or agency costs and they destroy trust, government legitimacy and surety of outcome.

The cost of development and creating or preserving wealth can be high. In part, each country will have to decide for itself if it wants to provide efficient domestic law or efficient international law. The existence of efficient international law does however change the national equation. It does this because countries have to take into greater account the desires of marginal users of their law. Knowing that there are marginal users, countries must decide if they want to retain marginal users by liberalizing law or let them go and tighten the law. One might find that there is a small country-big country (or rich and poor) divide in supply-side laws.

It is notable that small countries tend to be the largest suppliers of supply-side law. One can speculate that this too may be efficient. In small countries fewer people, all things being equal, tend to use the laws. This means that passing laws is more expensive in smaller countries relative to larger ones. Attracting more users amortizes the cost of the laws over a larger base. In large countries, unless there is a large exodus, less consideration has to be paid toward marginal users of the laws.

³⁹⁸ For example, as a result of deliberately laxer environmental laws, many American companies moved their factories to Mexico to make asbestos textiles and to Romania to make benzidine dyes. Parts of Africa were used as a toxic waste dump. F. Cairncross, "Cleaning Up", *Economist Survey* (September 8, 1990) at 30.

Chapter 7: Supply Side Tax Policies

Abstract

Efficient tax policies must take into account modern reality: Within a world where money flows at the speed of light, capital is difficult to tax. Moreover, we now live in a world where workers can telecommute to an office located anywhere in the world. This makes labour significantly more mobile. The days when money and skilled people were tightly bound to a country are gone. To highlight the implications of these changes, this chapter discusses the aim of the European 1992 programme, which is to provide a legal and business climate which offers firms equal opportunities throughout the European Economic Community, and compares it to what the countries are actually doing: becoming tax havens from their partner countries by supplying favourable tax laws and inward investment policies. Country by country variations in tax rules and rates provide firms with a menu of new choices and cause them to alter their mode of operation by offering an arbitrage situation with (both intended and unintended) economic and financial incentives. This chapter offers a market analysis of how country to country variations in tax and investment laws redirects investment patterns and shows how individuals, companies and countries may benefit from exploiting these areas. The chapter concludes by asking whether it makes much sense to tax capital under these circumstances and discusses the implications of the changing world for public finance.

Chapter 7: Supply Side Tax Policies

"Land is a subject which cannot be removed, whereas stock easily may. The proprietor of land is necessarily a citizen of the particular country in which the estate lies. The proprietor of the stock is properly a citizen of the world, and not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country he left. Stock cultivates land, stock employs labour. A tax which tended to drive away stock from any particular country, would so far tend to dry up every source of revenue, both to the sovereign and to the society."³⁹⁹

In a world in which money and people are increasingly mobile, tax revenues are harder to obtain and retain. In this context it is useful to outline how in traditional theory governments are supposed to operate under a different set of constraints than firms. In 1961, Ronald Coase wrote that: "The government is, in a sense, a super-firm (but of a very special kind) since it is able to influence the use of the factors of production by administrative decision. But the ordinary firm is subject to checks in its operations because of the competition of other firms which might administer the same activities at lower cost, and also because there is the alternative of market transactions against organization within the firm if the administrative costs become too great. The government is able, if it wishes, to avoid the market altogether, which a firm can never do."⁴⁰⁰ Coase was right in theory, but his theory of the power of government, like his theory of the firm has been outdated by technology.

Avoiding the market in the modern world has become increasingly difficult and expensive. As long as information flows freely through written sources, satellites, radio waves, television signals, and telephone wires, the government's ability to avoid the rigors of a free market are extremely limited, as the former leaders of former east bloc countries, Rumania, Albania, and Mongolia, and the monolithic leadership of Serbia, Cuba, North Korea and Myanmar (Burma) will certainly attest to. Because markets cannot reasonably be avoided, and labour and capital are (at least partially) mobile, governments must to some extent compete with each other for investment capital and precious tax revenues. This chapter will explore the global and inter-governmental competition (with a special emphasis on the European Community) for personal and corporate income tax revenues.

Section 1: Taxes and the European Community

The aim of the 1992 programme is to allow European businesses to operate freely anywhere within the European Community without constraints. The intent is to create a common market where companies operate under similar business conditions throughout the Community. Since European companies have to face both national and international competition, it is important that they should be able to do so on the broadest possible terms of equality and neutrality. Large variations in member states' tax laws make this goal impossible. But the 1992 programme does not address the harmonization of most aspects of personal and corporate tax law. The most visible and best understood business tax is the corporate tax rate. The corporate tax rate within the European Community currently ranges from 10 per cent in Ireland for some types of investment to 56 per cent in some Länder in Germany. Under these tax rate differences, an investment in Germany must earn almost twice the pre-tax return to be equivalent to an investment in Ireland.⁴⁰¹ Since most financing decisions are dependant on

³⁹⁹ A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) Reprint (Oxford: Clarendon, 1976) at 800.

⁴⁰⁰ R.H. Coase, "The Problem of Social Cost" (1961). Reprinted in *The Law, the Market and the Firm*, (Chicago and London: University of Chicago Press, 1988) p. 117.

⁴⁰¹ M. Devereux and M. Pearson, "Corporate Tax Harmonization and Economic Efficiency", *Institute for Fiscal Studies* (Report Series No. 35, 1989).

the proposed project's tax impact, investors will continue to use the laws of various countries against each other on a wide-scale basis.

As indicated in the preceding chapter, companies have considerable latitude to choose from the menu of the various national laws found around the world. Most investors are responding to this freedom by trying to profit from globally available differences in tax and investment treatment. Most countries have some element of being a "tax haven" since a tax haven is defined as "a jurisdiction: (a) where there are no relevant taxes; (b) where taxes are levied only on internal taxable events, but not at all, or at low rate, on profits from foreign sources; or (c) where special tax privileges are granted to certain types of taxable persons or events."⁴⁰² In Europe, while no countries fall under the first definition, most countries fall under either the second or the third definition. Perhaps even more importantly, even within the EC, various member states are supplying laws in order to make themselves tax havens from their European Community partners.⁴⁰³

Investors have naturally exploited regime difference to take advantage of variations in intra-country tax laws. To do this they have spent a lot of time and money to hire accountants, consultants and tax lawyers to look for loopholes, do comparative investment shopping and change their legal and operating structures to minimize their tax bills. Countries feel as if they have lost much needed tax revenue to cut-throat competitors and have reacted by entering into a competitive bidding process for investment and corporate and other tax revenues.

In Europe, this competitive process must be compared with the European Commission's stated intention to create a common market where companies operate under similar business conditions throughout the European Community. The Treaty of Rome, which created the European Community effective January 1, 1958, aims at the formation of a common market in which goods, persons, services, and capital can move freely. A fundamental premise that underlies the creation of the EC is that, by strengthening the whole, better safeguards can be created for preserving the integrity of the constituent parts. It was assumed that no contribution would be made to the Community's welfare if the inequitable and distortive tax structures of some members were imposed on other members.⁴⁰⁴

Background

The wide array of company, investment, tax and labour laws in Europe gives latitude and provides both incentives and disincentives to businesses when they select the location for their companies' main incorporation, the site of their production activities and to a certain extent the countries in which to pay certain taxes.⁴⁰⁵ This

⁴⁰² B. Spitz, International Tax Planning, Second Edition, (London: Butterworths, 1983) at 31-32.

⁴⁰³ With varying degrees of effectiveness, Belgium has its coordination centres; Denmark has holding companies; France has incentives for headquarter operations; Great Britain, Ireland and the Netherlands allow consolidated balance sheets under certain conditions; Greece has special provisions for shipping companies and offshore branches; Ireland has a 10 percent corporate tax and export sales relief for certain activities; Luxembourg has special provisions for holding companies, financial holding companies, bank holding companies, investment advisory companies, milliardaire holding companies, investment funds, unit trusts, variable capital share investment funds, fixed capital share investment funds and investment advisory companies; the Netherlands has special provisions for investment companies and groups of companies; Portugal has provisions for groups of companies, holding companies, leasing companies and investment companies; and West Germany has provisions for groups of companies and the GmbH & Co. KG, which if structured correctly is practically exempt from German corporate tax. Only Italy and Spain lack of these types of provisions.

⁴⁰⁴ S. Cnossen, "The Case for Tax Diversity in the European Community", 34 European Economic Review 471-479 (1990).

⁴⁰⁵ As a result of new competition, European companies will intensify their battle for competitiveness. With none of the existing non-tariff obstacles, increasing attention will be focused on labour costs. The mobility of labour will be stimulated by investment opportunities, career opportunities, and multinational

amounts to an arbitrage situation for companies. Given this freedom it is unlikely that companies will choose to remain primarily organized and incorporated in countries where they have to pay higher taxes, give shareholders less control and workers more rights, are subject to unfriendly takeovers or have less access to cheaper financing than they have to.

Companies use differences in company, tax and other laws for their own advantage. This has been going on for hundreds of years.⁴⁰⁶ Countries that wish to retain companies in their current forms will be forced to compete with their neighbouring countries which are eager to attract investment and employment within their borders by providing companies with a more favourable business environment. The limitation of a government's freedom to act in an environment with competitive neighbouring jurisdictions is illustrated by the following example. The Four Seasons Hotel chain wanted to build in Beverly Hills, California. Beverly Hills did not want the additional traffic that would come by having an additional hotel, so they denied it a building permit. So neighbouring Los Angeles issued a building permit for a site just across the street, on its side of the boundary. In the future, Los Angeles will enjoy the additional sales tax revenues and Beverly Hills will get the unwanted traffic.⁴⁰⁷ Beverly Hills must ask itself whether it may have won the battle, but lost the war. Other governmental actions have similar effects. Hard as they may try, governments generally cannot stop entrepreneurial activity; usually the best that they can do is to send the (taxable) activity elsewhere.

Markets for Investment

In a world where investors have a wide-ranging choice on where to invest, countries are falling over themselves to create an attractive business climate. The easiest way is to lower corporate tax rates and grant tax concessions and other investment incentives.

There are various interrelated markets for investment. As companies invest and disinvest they are faced with a trade-off between tax regimes, corporate structures, access to capital markets, various types of government inducements and deterrents, available infrastructures, transportation and communications, and the quantity, quality and the cost of the labour market and professional services. When looking at this list one thing is clear: the least important item on the list by a wide margin is the tax regime. Of paramount importance is the ability to produce products and services (including financial services) in an efficient and profitable manner. Corporate structures, infrastructure and the available work force are integral parts in this calculation. No amount of tax concessions can make up for shortcomings in these areas. In order to pay corporate taxes a business must be profitable in the first place. From this perspective, the tax rate and the place where taxes will be paid will always be of secondary importance once an entry decision has been made.⁴⁰⁸

The 1992 programme aims to promote increased cross-border trade within the community and decrease the need for companies to have complete independent operations in every country. As barriers to cross-border trade fall and pan-European product standards are introduced, and it becomes easier to supply national markets from abroad, tax considerations are likely to become more important. Rather than having duplicate functions in various countries, companies are increasingly creating Community-wide operations with single manufacturing, marketing

education programs. G. Becher, "EC Social Policy and the Financial/Trade Barriers", 18 Benefits & Compensation International (March 1989) pp. 18-20.

⁴⁰⁶ See R.B. Ekelund, Jr. and R.D. Tollison, "Mercantilist Origins of the Corporation", 11 Bell Journal of Economics 715-720 (1980).

⁴⁰⁷ "California: Think Middling", The Economist (August 10, 1991) p. 34.

⁴⁰⁸ Obviously the amount of taxes to be paid is an important part of the decision whether to enter a market or not. Higher tax rates affect the riskiness of the proposed endeavour. The higher the tax rate the lower the expected after tax return. The downside risk remains primarily with the investor, profits are shared with the tax man.

and distribution operations. These operations will not necessarily be in the same country. The tax systems provide some incentives to place these groups in separate countries.

Section 2: Tax Policies Affecting Companies

There is a wide array of tax policies affecting companies which distort investment patterns. These include personal tax rates, the ability to consolidate balance sheets, value added taxes, excise taxes, withholding taxes, transfer pricing policies, debt versus equity policies and corporate tax rates. The fact that there are some significant differences in tax rates and tax policies means that more strategic tax planning will take place in a post-1992 Europe.⁴⁰⁹ Additionally, the EC struggle to harmonize indirect taxes (value added, excise and withholding taxes) is likely to fade into the background in the coming years. When this happens, the important battleground is likely to shift to variations in corporate and personal taxes.

Consolidated Balance Sheets

When choosing where to locate, a parent corporation does not relish the possibility of paying corporate taxes on profits which were previously taxed in the country where the profits were realized. These "soak-up taxes" can occur when the profits of a foreign subsidiary corporation are repatriated to the parent corporation and the corporate tax rate in the country of the parent is greater than the corporate tax rate in the host country of the foreign subsidiary.⁴¹⁰ In Europe, at present only the Netherlands and Denmark universally allow a wide range of companies to consolidate their balance sheets. Upon receiving permission from the Minister of Finance, French companies may also consolidate their balance sheets. This can help eliminate "soak-up taxes" by allowing the parent corporation to consolidate the world-wide profits from all its subsidiary companies. Consolidation allows profits derived from both higher and lower tax countries to offset each other at least to some extent. The other European member states partially soak-up dividends repatriated from lower tax countries, as they are not off-set by the tax credits which are otherwise obtained from the dividends repatriated from higher tax countries. This is the worst of all possible worlds.

To compensate for this type of tax treatment, companies carefully repatriate dividends from higher to lower tax countries in order to pay less or no taxes and are generally able to allocate their resources in manners which

⁴⁰⁹ After two decades of deliberation on this topic, the EC adopted three measures to decrease fiscal impediments to market integration: (1) a directive that will defer the taxation of capital gains from share exchanges in cross-border, intra-EC mergers and acquisitions; (2) a directive that will eliminate multiple taxation of profits distributed from a subsidiary in one member state to its parent in another; and (3) a convention designed to ensure that profit adjustments made to sales between related companies in different member states will not result in double taxation. Although proposals for tax consolidation and for the harmonization of corporate tax rates are under consideration, these three measures represent substantially the entire framework for the EC's corporate taxation law. See D.C. Donald, "Taxation for a Single Market: European Community Legislation on Mergers, Distributed Profits, and Intracompany Sales", 22 *Law & Policy in International Business* 37-73 (1991); and J. Fox, "European Community Tax Directives", *International Tax Journal* (Spring 1991) pp. 45-50.

⁴¹⁰ For example, X corporation is located in country A. Y corporation is X corporation's 100% owned subsidiary and is located in country B. The corporate tax rate in country A is 50%. The corporate tax rate in country B is 40%. When the profits of Y corporation are sent to X corporation, country A "soaks-up" the 10% tax rate differential. Another somewhat related situation occurs when "phantom tax credits" are not recognized under a double taxation treaty. A "phantom tax credit" is a credit for taxes that would have been owed but for some type of tax forgiveness or investment tax credit. In this example, Y corporation was given a tax incentive that precluded it from paying the entire 40% tax on its profitable operation which would have been otherwise due in country B. Since there is no agreement between the two countries, country A is happy to tax the entire repatriated dividend at its 50% corporate tax rate.

avoid this from happening. This process is inefficient since it can prevent companies from allocating money within their worldwide organization to its best economic use.⁴¹¹

Transfer Pricing

"Today much of what is actually 'traded' across borders are intangible services - research, engineering, design, financial, management, marketing, and sales - transferred within global corporations from one location to another."⁴¹² The increasingly global nature of the firm makes matters more difficult for the tax man. To illustrate, let's try to follow the specific monetary flows of one product: General Motors' Pontiac Le Mans automobile. "Of the \$20,000 paid to GM, about \$6,000 goes to South Korea for routine labour and assembly operations, \$3,500 to Japan for advanced components (engines, transaxles, and electronics), \$1,500 to West Germany for styling and design engineering, \$800 to Taiwan, Singapore, and Japan for small components, \$500 to Britain for advertising and marketing services, and about \$100 to Ireland and Barbados for data processing. The rest - less than \$8,000 - goes to strategists in Detroit, lawyers and bankers in New York, lobbyists in Washington, insurance and health care workers all over the country, and General Motors shareholders - most of whom live in the United States, but an increasing number of whom are foreign nationals."⁴¹³ Now assuming that GM used its own fully-owned subsidiaries to develop the Le Mans (an unreasonable assumption for reasons given in chapter 5), GM must now apportion its profits throughout its worldwide web of subsidiaries.

When locating various functions of businesses in various countries, businesses must constantly ask themselves how to split the profits of their entire operation between its parts. Companies have obvious incentives to report as great a profit as possible in lower tax countries and as little as possible in higher tax countries. National tax laws require that goods and services be internally priced when moving from one subsidiary to another. This process is called "transfer pricing."⁴¹⁴ Tax authorities need a "transfer price" to assess the profitability of the national operations.⁴¹⁵

As the amount of world trade and intra-firm trade increases this issue takes on increased importance.⁴¹⁶ Tax problems arising from international and inter-company transactions have increased as multinational organizations

⁴¹¹ Various examples of this can be found in the articles cited in the next section.

⁴¹² R.B. Reich, "Who is Them?" 69 Harvard Business Review 77-88 (March-April, 1991) at 84.

⁴¹³ R.B. Reich, The Work of Nations (New York: Alfred A. Knopf, 1991) p. 113.

⁴¹⁴ Transfer pricing can be defined as the exchange of goods or services within a company at a market-determined price. D.P. Keegan and P.D. Howard, "Making Transfer Pricing Work for Services", 165 Journal of Accountancy 96-103 (1988).

⁴¹⁵ The concept of transfer pricing is that, within a manufacturing firm, one department, on transferring its output to another department, should regard this transfer as a sale. There are four alternative transfer pricing policies: (1) cost price; (2) cost plus a profit; (3) market price; and (4) dual pricing. In cost pricing, the disclosure and isolation of adverse variances at the transfer point will provide an incentive to the transferor to improve or maintain efficiency, benefiting both transferee and transferor. The cost plus a profit method is similar to cost price, but the transferor department will obtain a profit on transfers at total or standard cost and recover some or all of its fixed costs. When the market price method is adopted, the transferor department is in direct competition with outside suppliers. With a dual pricing policy, the transferor department can be allowed to sell at a high transfer price while the transferee is allowed a lower price. Difficulties arise as there is rarely a single transfer price to meet every need. A. Galway, "Transfer Pricing - Choice", Management Decisions (March 1990) pp. 18-21.

⁴¹⁶ Moreover, an analysis of the real implications of the tax-saving motivation behind intra-firm trade shows that, if the transfer price does not lie within too narrow a range, the intra-firm export of final goods will always be perverse. C. Kant, "Perverse Intra-Firm Trade", 56 Southern Economic Journal 233-235 (1989).

and their volume of business have grown. Problems arise when prices charged by one member of a multinational enterprise group to another do not necessarily represent the result of the free play of market forces.⁴¹⁷ Not surprisingly, "Transfer pricing is emerging as the issue of the 1990s."⁴¹⁸

Opportunities for tax planning become available because there is no one correct transfer price. Businesses can choose from a wide range of commercially justifiable transfer prices.⁴¹⁹ While allocating internal pricing is a fairly complex process for tangible items, the questions which arise over intangible items⁴²⁰ such as research and development, patents and copyrights, marketing, distribution, goodwill⁴²¹ and the new debate over brand-name accounting make transfer pricing even more difficult. This complicated situation arguably gives companies expanded powers for picking the transfer prices with the greatest tax advantages. As a result, companies place the minimum "commercially justifiable" profit in higher tax countries.

One can conclude that businesses should locate valuable intangible property in low tax areas. This makes the location of the manufacturing operations relatively less significant than a generation ago, since today one can reasonably argue that the manufacturing process itself adds little to a company's profits. To businesses this pricing policy is seen as an important opportunity for tax planning; to the tax collector this process is seen as a form of tax evasion.⁴²² There is little that the tax collector can do as long as pricing policies are consistent and the pricing is documented and commercially justifiable.

One should remember that with the advent of the microchip and modern communications systems, numbers representing money can be transferred by managers to almost anywhere in the world at the speed of light. This ability to transmit money across national boundaries can lead to shifting physical capital stock to multiple locations around the world. It also reduces the tax man's ability to monitor both money and profits. This in turn is forcing legislators and regulators to carefully rethink how, why and whether they can or should impose economic, regulatory and political constraints on investors.

⁴¹⁷ H.M. Liebman and P. De Boeck, "The International Transfer Pricing of Services", Tax Management International (July 8, 1988) pp. 291-99.

⁴¹⁸ M. Burge, R.M. Hammer and M.F. Urse, "Transfer Pricing: Part 1: New York Seminar Discusses Disclosure, Penalties and Control", 17 International Tax Review 1-8 (1991) at 1.

⁴¹⁹ J. Ronen and K.R. Balachandran, "An Approach to Transfer Pricing Under Uncertainty", 165 Journal of Accounting 300-14 (1988).

⁴²⁰ See R.F. Reilly, "The Valuation of Intangible Assets and Intellectual Properties", Buyouts & Acquisitions (January-February 1988) pp. 24-30.

⁴²¹ Owning a company no longer means what it once did. Accountants use the term goodwill to signify the difference in the "net worth" of the shareholder's equity and the value of the capital assets of the firm. This becomes increasingly important as a firm's intellectual capital becomes more important than its physical capital. An illustration of the importance of goodwill can be shown by General Electric's (a United States registered company, no relation with the British registered company with the same name) "acquisition" of the investment banking firm Kidder, Peabody. Upon acquiring Kidder, Peabody's assets, GE attempted to exert its control by imposing stricter reporting requirements, reducing commissions and tightening cost accounting. As a result, many of Kidder Peabody's most talented personnel departed for more congenial surroundings. Supra note 15 at 103.

⁴²² Germany, for example, is questioning the amount of business which German banks are filtering through Dublin with its flat 10% corporate profits tax because the profits do not get further taxed in Germany. S. Laurie, "Keeping Dublin Clean", The International (September 1991) pp. 69-72 at 70.

Debt Versus Equity

Closely related to the transfer pricing issue is the question of how to finance a multinational company. Companies have a wide amount of discretion to place varying amounts of debt and equity in their various subsidiaries. Since interest payments are deductible against current income in every country, companies have an incentive to place as much debt as possible in higher tax countries and as much equity as possible in low tax countries. Tax authorities are aware of companies loading debt onto subsidiaries in high tax countries. These "thinly capitalized" companies have been attacked and portions of the interest payments have been disallowed. American and Japanese authorities generally attack subsidiaries with more than three parts debt to one part equity.⁴²³ European authorities have yet to devise hard and fast rules. Great Britain's Inland Revenue has sought out views on the subject and the Germans have issued discussion papers. German tax law provides one way around the thin capitalization problem. Banks in Germany receive tax relief on their investments in preference shares. This tax benefit can be passed on to the companies which issue the shares. This reduces a company's cost of financing. The debt-to-equity ratio is lowered under this scheme since preference shares count as equity.⁴²⁴

Corporate Tax Rates

"The reduction of [the personal and corporate] income tax rate is probably the most dramatic manifestation of the wave of tax reform that swept the world in the 1980s, as well as perhaps the most important."⁴²⁵ Under the current international system, higher corporate tax rates induce companies to source their income in lower tax countries. This has become apparent to European corporate tax planners (see Table 1 below). Germany, Belgium, France, and Denmark have recently cited competition as the reason for lowering their corporate tax rates.⁴²⁶

Table 1 (See Appendix 1)

⁴²³ The American treasury is so concerned about over-leveraged corporations that in the beginning of 1992 it began publicly discussing the elimination of the tax differential between debt and equity. Additionally it is also discussing the elimination of the double-taxation of corporate profits and the dividends paid to shareholders. This would neutralize the decision between retaining earnings or paying dividends. "This Week in Business", The Economist, (January 11, 1992) p. 53.

⁴²⁴ R. Waters, "Chaos More Likely Than Harmony," Financial Times (March 13, 1989) p. 28.

⁴²⁵ C.E. McLure, Jr., "Appraising Tax Reform", in M.J. Boskin and C.E. McLure, Jr. (eds.), World Tax Reform, (San Francisco: ICS Press 1990) pp. 279-88 at 282.

⁴²⁶ See T. Dickson, "Belgium Pleads with IMF over Tax Competition", Financial Times (May 15, 1990) p. 2; D. Buchan, "Belgian Coalition Tries to Hold the Line on Spending," Financial Times (July 28, 1989) p. 2; ; C. Parkes, "Möllerplemann pledges to cut Corporate Tax", Financial Times (September 6, 1991) p. 16; and "France Drafts Budget Designed to Spur Growth", International Herald Tribune (September 12, 1991) p. 5.

There is an obvious downward spiral in corporate tax rates. Perhaps an equilibrium point will be reached, but it is impossible to see - short of zero - how low this point may be.⁴²⁷ This downward spiral may eventually convince governments of their need to harmonize corporate tax rates.⁴²⁸

There is little chance that the European Community will end this downward pressure in the near future through rate harmonization. Tax rates at between 45-55 per cent, is already hopelessly outdated and unrealistic.⁴²⁹

In addition, one should note that tax rates alone mean little without a basis of comparison on how much tax is due. This is an important question since no two corporate tax regimes are consistent. Both accounting rules and the basis on which taxes are calculated differ on a country by country basis. This ensures that companies in different countries, with similar levels of sales and costs, will have the same level of "profits." This is why there seems to be little correlation between the tax rate (see Table 1) and the amount of corporate tax collected (see Tables 2 and 3).

Supply Side Economics

The country which has the lowest corporate tax rates has a lot to gain. Companies will attempt to source as much income in the lowest tax country as commercially justifiable.⁴³⁰ At the very least, companies could source intangible items which are not generally directly associated with real economic activities in countries with the lowest tax rates since one can commercially justify that a portion of the profits are attributable to these legal papers and accounting items. These intangible items include: patents, goodwill and brand names. Additionally, some profits could probably be attributed to the country of the parent company's incorporation. At this point supply-side laws and supply-side taxes make a winning combination. It would make sense for a country with the most liberal company laws to also have the lowest corporate tax rate. Moreover, supply-side countries would almost certainly obtain a large windfall since companies would happily volunteer to pay the taxes owed, with little collection cost or tax monitoring. This process proves to be one of the better cases for supply-side

⁴²⁷ In 1992, eight European countries have their rates bunched in the 33-39 percent range. Sweden, which has already applied for European Community membership, has announced that it will slash its corporate tax rate to 25 percent in 1993. R. Taylor, "Sweden Takes Sharp Centre-Right Turn", Financial Times (November 13, 1991) p. 2. This is less than one-half of the 1990 rate of 52 percent. I. Hansson and C. Stuart, "Sweden: Tax Reform in a High-Tax Environment", in M.J. Boskin and C.E. McLure, Jr. (eds.), World Tax Reform (San Francisco: ICS Press 1990) pp. 127-148 at 147.

⁴²⁸ The 1986 U.S. tax reform could be characterized as the initial aggressive shot which started a war of international tax competition. It introduced substantial reductions in U.S. statutory corporate and personal income tax rates which created a tax rate differential to which other countries had to respond. Tax reform also introduced significant structural changes into the taxation of foreign source income of U.S. taxpayers, which increased the importance of international differences in tax rates. Other governments have rapidly introduced similar reforms. Peggy Musgrave, for example, recommends that those nations that have economies linked by trade and factor flows should work toward an international tax order to align or neutralize those taxes most apt to affect international resource allocation. The corporation tax in the international arena should be recognized as a means of claiming a tax share of income accruing to investors from abroad. See J. Bossons and P.B. Musgrave, "International Tax Competition: The Foreign Government Response in Canada and Other Countries; Comments in Session on 'Foreign Reactions to U.S. Tax Reform'", National Tax Journal (September 1988) pp. 347-355, 365-366 and J.G. Heimann, "Global Harmonization Required to Prevent Regulatory Arbitrage", Financier (May 1988) pp. 29-33.

⁴²⁹ D. Waller, "Corporate Taxation Escapes EC's Single Market Net", Financial Times (January 15, 1990) p. 2.

⁴³⁰ C. Kant, "Multinational Firms and Government Revenues", 42 Journal of Public Economics 135-147 (1990).

economics: decreasing tax rates to the lowest rate will greatly increase the revenue received by the supply-side country.

Conversely, this process should greatly lower the amounts of corporate taxes collected in higher tax countries. As long as the cost of "moving" to another country is less than the net present value of the taxes that could be saved, companies that operate in high tax countries will find it beneficial to open some kind of structure which includes a second low tax country simply for tax minimization purposes. This will level the playing field to some extent with competitors who pay less tax.

Withholding Taxes and the Taxation of Investment Income

The existence of withholding taxes can also influence investment flows. In 1989, the European Commission proposed a 15% withholding tax on interest and dividend payments. So far it has met determined resistance.⁴³¹ Withholding taxes are inhibitions to a truly single market since they are an indiscrete attempt to tax foreigners. If interest, dividends and royalty payments are made to domestic companies, withholding taxes are generally not due. If these same payments are made to foreign companies, including companies from other Community member states, withholding taxes are generally due.

Countries which use the residence principle for cross-border interest income do not tax dividends in the country where the interest was earned, but let the tax authorities of the place of residence try to collect taxes. The residence principle tends to equalize interest rates across countries despite different capital income tax rates. One problem with this principle is that it does not work well if investors are dishonest, as they can almost always more easily conceal their foreign interest income than their domestic interest income.⁴³²

The lack of agreement over withholding taxes and differences in tax systems is an incentive to own investments outside the country of one's residence. Investors who wish to avoid tax payments will increase their demand for shares and bonds in non-withholding tax countries. This has the positive effect of driving up security prices and lowering a company's cost of issuing debt and equity. In this respect, securities not subject to withholding taxes might be analyzed as a type of tax free security. Tax free securities benefit different investors in different ways. Some investors (those who avoid paying the most tax on the income) stand to benefit more than others.

Investment Subsidies and Incentives

Almost every government in the world is eager to attract local investment and the money and jobs which investment brings. Not surprisingly, governments compete actively for inward investment.

Table II (See appendix II after this chapter)

⁴³¹ Where enacted in Europe, withholding tax rates range from 10 percent in Portugal to 35 percent in Ireland. In the EC, there is a nine-three country split on the withholding tax issue. The three no votes are Luxembourg, Great Britain and The Netherlands. Finance Minister Jacques Poos, articulated Luxembourg's opposition to withholding taxes by stating: "My country is not ready to play policeman and tax collector for its partners." D. Buchan, "Plan for EC Minimum Savings Tax Gets Rough Ministerial Ride," *Financial Times* (February 14, 1989) p. 1. It is unlikely that the necessary unanimous vote in the Council of Ministers can be obtained in the near future. In 1989, Germany briefly enacted a 10% withholding tax on interest income. It lasted only four months because it proved widely unpopular and it sent capital abroad. This capital flight weakened the mark which led to its quick repeal. "West Germany Scraps its Withholding Tax", *International Herald Tribune* (April 28, 1989) p. 19. At the end of 1991 Germany reintroduced a withholding tax which was well received by the financial markets as it had an adequate number of exemptions.

⁴³² H.W. Sinn, "Tax Harmonization and Tax Competition in Europe", 34 *European Economic Review* 489-504 (1990).

It is not only prestige which is at stake. In addition to the prospect of collecting corporate taxes, many other benefits accrue to municipal, county, state, regional and national governments. In fact, the other sources of taxes are much more attractive.

Of foremost importance are the taxes which are associated with employment. These taxes include personal income taxes and social security contributions of various types. Increased income generally stimulates consumption and augments value added and consumption taxes. Land values are generally increased and property tax collections are augmented. The increased use of public utilities helps create economies of scale, which decreases marginal and average costs and increases public utility profits. In fact, over the past 35 years, governments have received a decreasing amount of their tax revenue from corporate sources (see Table 2 above).

As governments derive a windfall from investments, not surprisingly the competition for this windfall is often fierce and a form of bribery occurs. Investors know that their investment brings wealth, prosperity and prestige and they naturally ask for a kickback. These kickbacks are perfectly legal. They come in the form of subsidies and investment incentives such as tax incentives and holidays, staff training, free land, free buildings, free infrastructure, guaranteed local contracts, etc.

Economic incentives have been used to attract businesses for many years. The current debate on the merits of economic incentives has arisen because of the meteoric rise in the amounts offered.⁴³³ For example, Toyota was looking for a location in the United States for an \$800 million plant which would employ 3,000 workers. Many states offered Toyota generous investment incentives in the hope that these would induce the firm to select their state. Kentucky won the competition, but the price was high - the present value of the direct payments exceeded \$125 million (\$41,666 per job created).⁴³⁴

This type of incentive is not limited to the United States. To see what is currently on offer, one can consult any bank or large accounting or law firm to get advice. In addition to these (rent-seeking) sources, there are at least two glossy magazines wholly devoted to what is on offer in Europe and internationally.⁴³⁵

Table 3 (See appendix III after this chapter)

Should Corporations Be Taxed?

The problem with incentives and subsidies is that they are not fixed or transparent - often everything is negotiable. Because they are not transparent some firms tend to do better than others. As a result, success can be derived from being a better negotiator, not a better businessman. What is certain is that transparency is all but absent from many governmental activities to attract investment.

As long as governments are spending a vast amount of money to attract capital and investments, capital flows are distorted from the location which offers the greatest economic return to the place which offers the greatest financial return. Since economic efficiency is necessarily lost in the process, this leads to the question of whether the benefit of having a corporate tax which yields limited corporate tax revenues outweighs the considerable costs which it imposes.⁴³⁶

⁴³³ A. Kolesar, "Can State and Local Tax Incentives and Other Contributions Stimulate Economic Development", 44 Tax Lawyer 285-311 (1990).

⁴³⁴ D.A. Black and W.H. Hoyt, "Bidding for Firms", 79 American Economic Review 1249-1256 (1989).

⁴³⁵ These magazines are Corporate Location Europe and Corporate Location International.

⁴³⁶ The costs include inefficient resource allocation, a lack of transparency, the costs of the subsidies and investment incentives, the cost of hiring and maintaining government investment 'pimps' in locations around the world, the cost of maintaining corporate tax inspectors, the cost of corporate tax compliance, and the dead-weight loss of tax lawyers and accountants.

Many governments are engaged in lowering tax rates because they have decided that high marginal rates are counterproductive, discouraging investment and hard work, while encouraging legal tax avoidance and illegal tax evasion. There is a growing disenchantment with investment incentives because they distort the allocation of resources⁴³⁷ and are not transparent.⁴³⁸ Corporate taxation has been demonstrated to produce an inefficient distribution of public good outputs across regions, accompanied by an inefficient pattern of trade.⁴³⁹

If one looks at Table 3 above, one may be impressed how stable the amount of corporate taxes collected has been in OECD countries over the last two generations. This is a distortion. To see the decreasing importance of corporate taxation, one must consider various countries on their own merits.

In Table 4 below, after eliminating Japan where corporate savings and profitability have mushroomed, seven country groupings are left. One can see that the United Kingdom's and Norway's (Oil Money) corporate tax receipts go up and down with the oil price. Luxembourg and Switzerland (Bank Havens) have increased corporate tax collection largely due to their supply-side banking laws. Southern Europe has seen relatively more corporations, more corporate activity and increased corporate profitability over this 35 year period, so one would expect corporate revenues to increase. Both the South Pacific countries of New Zealand and Australia and the North American countries of the United States and Canada have witnessed rapidly decreasing corporate tax revenues. One should note that this revenue is considerably higher than in Northern Europe. One of the reasons for this is that these countries are mineral and oil rich, which makes their figures higher than if they did not benefit from their natural resources. This leaves the Northern European countries.⁴⁴⁰ Here the amount collected is low (under five percent), and the trend is downward.

Table 4 (See appendix IV after this chapter)

All and all in a world of quicksilver capital, lowering tax rates must be considered much more attractive for most countries than continuing and augmenting the subsidy and investment incentive war. As a result corporate tax rates will continue to trend downward for a considerable time to come.

Personal Income Taxes

Personal income taxes will have an increasingly greater effect on where companies will place certain operations. As the world increasingly becomes interconnected through international communications and travel, corporations have increased latitude to locate employees engaged in non-customer related services anywhere in the world. Divisions of companies that are particularly people intensive, such as head offices, research and development, distribution and marketing departments are quite sensitive to differences in personal income taxes. Since many employees are primarily interested in their after tax salaries, placing these types of operations in countries which have low personal income taxes should be the wave of the future. Sending an employee to a higher tax country without an offsetting rise in salary amounts to a pay cut.

⁴³⁷ D.R. Francis, "As Nations Vie to Cut Tax Rates, US is Envied Leader", *Financier* (January 1987) pp. 10-13.

⁴³⁸ One of the most important tax policy questions today is the extent to which large taxpayers have greater ability to avoid tax than the smaller taxpayers. D. Dixon and M. Soutter, "The Corporate Tax Breaks; The Burden of Corporate Tax", *Australian Accountant* (June 1988) pp. 33-37.

⁴³⁹ J.D. Wilson, "Trade, Capital Mobility, and Tax Competition", 95 *Journal of Political Economy* 835-856 (August 1987).

⁴⁴⁰ The Netherlands could easily fit into either the category of Oil Money or Northern European countries without distorting either category greatly.

As previously stated, in the 1950s, 70 percent of workers in Western Europe and the United States used their hands at work. Now 70 percent of these workers use their brains.⁴⁴¹ People who use their brains are very mobile. They can be in contact with their office, clients and customers through telecommunication, satellites, and lower cost international travel. The race to lower personal tax rates is coming because well paid jobs are increasingly going to people who have the highest mobility. The best paid jobs are going to individuals who create or process pieces of information. They include people involved in advertising, banking, consulting, finance, publishing, engineering, architecture, entertainment which does not involve personal appearances, investments, biochemistry, religion, the law, insurance, entertainment, education, sales, research, and computer software.⁴⁴²

The brain drain is a real threat.⁴⁴³ As a result of freer movement of people, Ireland and Greece are today losing some of their brightest graduates and students, who are seeking job prospects elsewhere. Spain and Portugal may also become vulnerable to the same problem as their economies develop within the European Economic Community. Meanwhile, policy makers in Ireland and Greece have to face the fact that the people with the most marketable skills are those who have the most choices, and inevitably, they are the ones who leave the fastest. Worse, these are the very people needed to develop the lagging economies of these two countries. According a recent study, 40% of Ireland's electronic engineering graduates and 26% of its computer science graduates from the class of 1986 had already left the country. The U.S. alone has an estimated 4,000 Greek research scientists, compared with just 5,000 residing in Greece itself.⁴⁴⁴

The most entrepreneurial of these workers will be particularly inclined to move to tax havens. In the prophetic words of Norman Macrae: "Areas which vote to have high taxes will be residually inhabited mainly by dummies: people who vote to have tax money spent on themselves, without actually earning enough money to be taxed."⁴⁴⁵ This is not merely conjecture. One only has to look at East Germany before reunification and Hong Kong as 1997 nears; the best and the brightest will flee in large numbers to countries which offer them better opportunities. In contrast to the relatively high skilled persons from East Germany and Hong Kong, there are the Cubans, Haitians, Tamils, Vietnamese and Albanians who have made sometimes heroic attempts to flee toward the United States, Canada, Hong Kong, Italy and other places only to be sent home. If these workers were perceived as having high skills, they would not have been sent packing so easily.

Closely related to the personal income tax rates issue is the question of social security and health care financing. Countries with the lowest employer-paid social security benefits and a taxpayer financed national health service will tend to attract people-intensive operations. Japanese factories are flocking to Great Britain partly because the British taxpayer-financed national health service means that employers in Great Britain do not need to bear the cost of medical insurance.⁴⁴⁶

⁴⁴¹ N. Macrae, "The Next Ages of Man", Economist Survey, December 24, 1988, p. 8.

⁴⁴² In this context, countries which have high telephone charges will be at a great competitive disadvantage. Restrictions and higher cost roads, rails, harbours and airports, put nations at a competitive disadvantage. This change in the nature of worker mobility and international competition will also have a great effect on the work place. Companies which do not take care of their employees will not be able to keep the good ones; those companies which place their operations in expensive locations will not be able to remain competitive.

⁴⁴³ C. Kennedy, "When Assets Walk Away", Director (May 1989) pp. 129-132.

⁴⁴⁴ D. Manasian, "The Exodus of the Elite", International Management (February 1988) pp. 54-56.

⁴⁴⁵ *Supra* note 43 at 8-10.

⁴⁴⁶ N. Macrae, "Now the Bad News About 1992", Business Month, (September 1989) pp. 20-22.

Section 3: Conclusion

An array of different sets of worldwide supply-side company and tax laws can provide great savings and greater control for companies which locate their incorporation in the country which provides the possibility for the most efficient operating structure and allows overall tax minimization. Companies can further minimize their taxes by placing as much debt as possible in high corporate tax countries, since interest payments are deductible against current income. Transfer prices should be manipulated to put as much profit as commercially justifiable in the lowest tax countries. Service operations (staff positions) should be directed to lower personal tax rate companies. Finally, shareholder equity should be directed to lower corporate tax countries, preferably in those countries without withholding taxes.

Many countries have designed tax incentive schemes to attract internationally mobile businesses. There are various inducements designed to further encourage companies to move their operation structures in order to save significantly on taxes. Some countries, such as Great Britain, are willing to negotiate on an individual basis (See footnote 5). Ireland has a 10 per cent tax on manufacturing and financial operations and Belgium has "co-ordination centre" inducements for locating a company's head office to Belgium.⁴⁴⁷ This provides further incentives for firms to navigate, negotiate and renegotiate on a continuing basis in the "European Single Market" and elsewhere.

It is quite likely that the problems caused by non-harmonized national tax rates and bases will mean that the European Community will still have some type of internal economic borders for some time to come, in spite of the aim to completely eliminate them by 1993. Intra-European trade will be considerably freer and intra-European competition much keener as a result of the initiative. This will be especially true in the area of financial markets and financial services. The 1992 initiative should be considered a process, and its "deadline" basically a device to force the member states along the evolutionary path toward a Europe without borders. This process will increase uncertainty for firms. For outsiders, the process will most likely be liberalizing, except in agriculture. Despite the strong protectionist pressures within Europe, there seems to be a genuine commitment among EC officials to enhanced competition.⁴⁴⁸

This competition should make life much more difficult for politicians and finance ministers in countries with the highest social welfare costs. It is obvious that there is a correlation between the amount of tax revenues required and the scope and cost of the social welfare system. With value added tax rates and excise duties in Europe converging with the coming of a pan-European customs union, countries must rely on their social welfare contributions and taxes on incomes and profits to fund governmental activities.⁴⁴⁹ Financial problems for higher social benefit countries will persist and magnify in the foreseeable future. This will happen since the

⁴⁴⁷ R. Waters, "Chaos More Likely Than Harmony", *Financial Times* (March 13, 1989) p. 28.

⁴⁴⁸ R.N. Cooper, "Europe Without Borders", 2 *Brookings Papers on Economic Activity* 325-340 (1989).

⁴⁴⁹ This problem becomes clearer when one considers that in 1983, taxes consisted of 47.5 per cent of the Netherlands' GDP, while in Spain the figure was less than 28 per cent. R. Leonard, *Pocket Guide to the European Community* (London: Basil Blackwell, 1988). This reflects some of the wide differences in social security provided in the two countries. Since this time the Netherlands has made some adjustments, some of them owing to the competitive pressures from their European partners. In the past few years, the Netherlands has lowered both VAT rates and corporate tax rates. It has also reformed its personal income tax structure in a manner that has also decreased revenues. Welfare benefits have been reduced to some extent. It is relying on economic growth and deficits to make up for the shortfall of revenues.

countries which have higher corporate and personal tax rates will lose some of their activities (or at least have their profits redirected) to lower tax countries.⁴⁵⁰

As capital becomes more mobile, governments will increasingly try to tax less mobile capital, property and people. Richard McKenzie and Dwight Lee suggest that as this happens, "owners of immobile capital will not 'play dead' and just take the greater burden imposed on them. They will do what they can to become *more* mobile. They might, for example:

- . Downsize their firms and plants, making themselves more 'mobile and hostile'.
- . Contract out the production of many of their needed intermediate parts and the provision of business services, facilitating the shift of more of their work to firms in other governmental jurisdictions.
- . Reduce the 'payout period' (or time over which the original investment is returned) on their plants, which will enable them to redeploy their investments more quickly and move out from under adverse governmental policies.
- . Rely more extensively on equipment (other than plant) in their production processes, which can be more easily moved to, or repurchased in, a new location.
- . Establish more production facilities in different governmental units so that production can be moved in response to changes in governmental policies.⁴⁵¹

This process will make monetary, investment and human capital more like 'quicksilver' (difficult to hold, shape, and contain). As this happens, even more pressure is placed on beleaguered governments. To attract investment capital and create jobs, governments will have to go down the competitive negative spiral of reduced tax rates or increased subsidies or investment incentives. Eventually this path will look unattractive to many countries. As this happens, the neutral investment attraction policy of not even attempting to tax profits on capital will become increasingly attractive.

The taxation of capital: (1) distorts world investment flows (investment is not always placed in the location where economic profits can be maximized); (2) may make operating through certain organizational forms (i.e. general and limited partnerships, sole proprietorships and trusts) more attractive than others (i.e. non-incorporated businesses and corporations); (3) is often not transparent; (4) is increasingly difficult to collect; and (5) has begun to cost governments more to obtain than it brings in (because of the intergovernmental competition to attract investment). For these reasons, investment taxation will probably eventually have to be abandoned. Governments which continue to tax capital at a rate higher than the market will bear will see money, investment and many of its most productive residents flee to the lands of supply-side tax policies.

⁴⁵⁰ Tax harmonization would not help countries with higher social welfare expenditures as a percentage of GNP since there would be some kind of relation between tax revenue obtained from harmonized tax rates and the size of the economy.

⁴⁵¹ R.B. McKenzie and D.R. Lee, Quicksilver Capital (New York: The Free Press, 1991) p. 243.

Appendix I

TABLE 1: CENTRAL GOVERNMENT CORPORATE TAX RATES, 1991

COUNTRY	CORPORATE TAX RATE
Germany	50
Greece	46
Belgium	39
Italy	36
Portugal	36
The Netherlands	35
Spain	35
Denmark	34
France	34
Luxembourg	34
Great Britain	33

Source: *The Economist* (March 23, 1991) p. 45 and *Financial Times* (December 6, 1991) p. 2.

Appendix II

TABLE 2: TOTAL CORPORATE TAX REVENUES AS A PERCENTAGE OF ALL TAX REVENUES IN OECD COUNTRIES 1955-1989

	1955	1960	1975	1980	1985	1989
Australia	15.9	16.9	12.4	12.2	9.3	12.6
Austria	6.0	5.9	4.3	3.5	3.4	3.7
Belgium	4.3	4.2	7.2	5.6	7.0	6.1
Canada	17.6	17.5	13.6	11.6	9.8	8.4
Denmark	5.8	4.6	3.1	3.2	4.8	4.2
Finland	11.1	8.9	4.3	4.5	4.1	4.2
France	N/A	N/A	5.2	5.5	4.5	5.5
Germany	8.4	8.4	4.9	5.5	6.1	5.5
Greece	N/A	N/A	3.4	3.8	2.8	4.6
Iceland	N/A	N/A	2.3	2.5	3.1	3.0
Ireland	7.4	6.4	4.8	4.6	3.2	3.7
Italy	5.5	6.8	6.3	7.8	9.2	9.9
Japan	18.4	28.0	20.6	21.8	21.0	24.4
Luxembourg	N/A	N/A	15.7	16.5	18.2	17.5
Netherlands	13.4	10.7	7.7	6.6	7.0	7.7
New Zealand	15.0	12.8	11.8	7.8	8.3	9.0
Norway	13.3	4.9	2.8	13.2	17.0	5.3
Portugal	N/A	N/A	N/A	N/A	N/A	3.9
Spain	N/A	15.5	6.9	5.1	5.2	8.6
Sweden	13.8	8.8	4.3	2.5	3.5	3.7
Switzerland	6.4	7.1	7.7	5.8	7.2	9.7
Turkey	3.5	4.4	N/A	4.1	9.5	8.4
U.K.	17.5	10.3	6.7	8.3	12.6	12.3
U.S.	20.3	17.2	9.3	10.2	7.1	8.5
Unweighted Average	11.6	9.8	7.5	7.5	8.0	7.9

Source: Revenue Statistics of OECD Member Countries 1965-1990, (Paris: OECD, 1991).

Appendix III

TABLE 3: TOTAL CORPORATE TAX REVENUES AS A PERCENTAGE OF GDP IN OECD COUNTRIES 1955-1989

	1955	1960	1975	1980	1985	1989
Australia	3.4	3.8	3.4	3.5	2.8	3.8
Austria	1.8	2.1	1.7	1.4	1.5	1.5
Belgium	1.0	1.1	3.0	2.4	3.3	2.7
Canada	3.7	4.1	4.4	3.6	3.2	2.9
Denmark	1.3	1.2	1.3	1.5	2.4	2.1
Finland	2.9	2.5	1.5	1.5	1.5	1.6
France	N/A	N/A	1.4	2.3	2.0	2.4
Germany	2.6	2.6	1.7	2.1	2.3	2.1
Greece	N/A	N/A	0.9	1.1	1.0	1.5
Iceland	N/A	N/A	0.7	0.8	0.9	1.0
Ireland	1.7	1.4	1.5	1.6	1.2	1.4
Italy	1.9	2.3	1.7	2.4	3.1	3.7
Japan	3.1	5.0	4.3	5.5	5.7	7.4
Luxembourg	N/A	N/A	6.1	6.8	8.0	7.4
Netherlands	3.5	3.2	3.4	3.0	3.1	3.5
New Zealand	4.1	3.5	3.7	2.6	2.8	3.6
Norway	3.8	1.5	1.3	6.2	8.1	2.4
Portugal	N/A	N/A	N/A	N/A	N/A	1.4
Spain	N/A	2.2	1.3	1.2	1.5	3.0
Sweden	3.5	2.4	1.9	1.2	1.8	2.1
Switzerland	1.2	1.5	2.3	1.8	2.3	3.1
Turkey	0.4	0.5	N/A	1.3	1.9	2.4
U.K.	5.2	2.9	2.4	2.9	4.8	4.5
U.S.	4.8	4.6	2.7	3.0	2.1	2.6
Unweighted Average	2.8	2.4	2.5	2.6	3.0	3.0

Source: Revenue Statistics of OECD Member Countries 1965-1990, (Paris: OECD, 1991).

Appendix IV

TABLE 4: CORPORATE TAX REVENUE AS A PERCENT OF ALL TAX REVENUE: AVERAGE
BY REGIONS 1955-1989

	1955	1960	1975	1980	1985	1989
N. America ^(a)	19.0	17.4	11.5	10.9	8.5	8.5
S. Pacific ^(b)	15.5	14.9	12.1	10.0	8.8	10.8
N. Europe ^(c)	9.4	7.7	4.1	4.3	4.4	4.6
S. Europe ^(d)	4.4	7.7	6.0	5.3	6.7	7.5
Bank Havens ^(e)	6.4	7.1	11.7	11.2	12.7	13.6
Oil Money ^(f)	15.4	7.6	4.8	10.8	14.8	8.8

(a) United States and Canada

(b) Australia and New Zealand

(c) Austria, Denmark, Finland, France, Germany, Iceland, Ireland, Netherlands and Sweden

(d) Belgium, Greece, Italy, Spain and Turkey

(e) Luxembourg and Switzerland

(f) Norway and the United Kingdom

Source: Revenue Statistics of OECD Member Countries 1965-1990, (Paris: OECD, 1991).

Chapter 8:
The Proper Source of Efficient
Commercial Law
in an International Environment:
Company Law and Capital
Markets

Abstract

In a world where individuals and firms have a choice of picking the laws under which they operate, greater thought must be given to the proper source of efficient law. Law which is efficient in this context must be based on the subsidiarity principle: laws should be passed at the lowest level where practicable. The proper source and form of efficient laws will depend on the law's purpose and the nature of the market which is meant to be regulated. Toward this end, this chapter will go into some detail regarding the future of laws regulating capital markets, currencies and the operations of companies. In the past, all were formerly regulated at the national, regional or local levels, but there is an increasing shift to the international or pan-national level. This chapter asks, at a time when money, capital markets and the structures of firms are increasingly becoming international in nature, which of these should be regulated by national, by regional and by international laws. It is argued that the international level is appropriate for capital markets, that currencies are best regulated at the point where economies become integrated, and that the national level is more appropriate for company laws. This is because the capital markets, in which capital seeks the highest rate of return for a given level of risk, are international. Company law, on the other hand, seeks to regulate the relationships of people and groups by either suggesting or imposing governance structures. The appropriateness of any given operating structure is determined by the working relationships, level of trust and national economic style of a company's stakeholders.

Chapter 8: The Proper Source of Efficient Commercial Law in an International Environment: Company Law and Capital Markets

"The Community shall act within the limits of the powers conferred by it by this Treaty and all of the objectives assigned to it therein. In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the purposes of an action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. Any action by the community shall not go beyond what is necessary to achieve the objectives of this Treaty."⁴⁵²

In the current international marketplace for commercial laws, there are three considerations to keep in mind when determining which types of commercial laws are efficient. First, as indicated in Chapter 6, certain areas of the law, most notably laws pertaining to financial markets, are becoming international in scope. Second, as indicated in Chapters 2 and 4, national, regional and local laws should be based and supplied on the principles of reducing transaction costs and increasing trust and certainty of outcome. Finally, as indicated in Chapter 6, there are supply-side laws which are a type of hybrid between efficient national laws and efficient international laws. Supply-side laws are laws which are passed by certain countries to attract internationally-minded firms and individuals. They are attractive because certain national commercial laws, while best addressing the needs of the majority of resident firms and individuals, cannot adequately address the needs of *every* firm or individual. As described in Chapter 5, technology has made the use of supply-side laws increasingly feasible. Some firms and individuals may require the rigidity of national company law, while other firms may well need less stringency (or in some cases more stringency) and will opt for a company law supplied by another jurisdiction.

Perhaps the critical reason why capital market laws and company laws are going in different directions, at a time when both capital and firms are increasingly international, is the decreasing importance of capital taxation. Over the past 20 years, computers have made money more mobile. Countries with stamp or turnover taxes or higher levels of capital regulation or taxation found that transactions were shifted to countries which offered lower costs (and more transparency and liquidity). Their only reaction to the loss of their capital market was to compete. As a result taxes have become lower and market laws have become more similar and less restrictive over the past decade.⁴⁵³

Information regarding investing outside one's borders was also more difficult to find before the onset of the information revolution. When capital was less mobile it was more easily taxed. Since the end of World War II, trade barriers have progressively been decreasing (as a result of the success of the GATT and regional free trade agreements) and there has been an explosion in world trade. Increased trade provides companies with greater choice in the place where they invest and provide employment. In this atmosphere, capital became less tied to the country where the wealth was produced. Since capital became less captive, countries were forced to become more internationally competitive in order to attract internationally mobile investment. The attraction of investment is of paramount importance since investment means taxable economic activity, skills, wealth and employment.

In the golden age of government, an epoch in which many are already nostalgic, capital mobility was limited. Limited capital mobility is almost a necessary condition for a wide variation in tax regimes. During this era, "an efficient operating structure" of a firm was based almost entirely on tax-efficiency (tax minimizing) reasons. In the age of mobile capital, capital taxation is decreasing in importance. As a result, lawyers, financiers, economists and governments increasingly have to think of "an efficient operating structure" in terms of minimizing economic risk and transaction and agency costs. This chapter analyzes what are efficient capital market laws and efficient company laws in light of this historic change.

⁴⁵² Treaty on European Union, Article 3b, as reported in Europe Documents (February 7, 1992) pp. 2-4.

⁴⁵³ I. Swary and B. Topf, Global Financial Deregulation, (London: Blackwell, 1991).

Section 1: Capital Markets

The purpose of this book has been to describe what efficient commercial law should accomplish. Money (in its various forms) has increasingly become a commodity over the past decade. While money is still denominated in names like "dollars," "yen," "pounds," "francs," "marks," "lira," "guilders," "pesos" and "pesetas," it has been increasingly traded in its various forms (which include commodities or services)⁴⁵⁴ on international markets where investors seek to find its highest return at a given level of risk. With modern computers and software, money flows internationally through fibre optic cables and is traded in its various forms across various markets. Because the marginal cost of making an additional trade is almost insignificant, arbitrage has become increasingly difficult. In this international search, the names of the currencies do not matter very much; only the value of the "currency" is important. The name is important because the name attached provides different levels of perceived and actual risks. As the nature of money becomes less and less tied to any particular country, the rules needed to regulate money become more international. In this respect, form is truly following function. Efficient law for capital markets are those which make markets transparent, increase liquidity and lower costs. In this competitive market, it should come as no surprise that improvements in the legal settings of various markets are quickly copied by legislators and regulators in other countries.

Many people presume that only the forces of deregulation have been at work in the various capital markets over the past decade. This is not true. The results have been bifurcated. While deregulation measures have been introduced to take vested power away from entrenched stockbrokers, other regulations have been introduced to increase the transparency of markets. The important capital markets outside of the United States, i.e., Germany, France, Japan, Spain, Italy and the Netherlands have all taken steps against insider trading. The United States and Great Britain have sent some of the richest, most well-known and most powerful abusers of its capital markets to jail, all in the name of protecting the transparency of their markets.⁴⁵⁵ Lower cost and more transparency are the key elements to increased liquidity.

These actions are not without sound economic objectives. Increased liquidity often means valuable increased economic activity. The increased activity represented by flows of capital usually means that there will be more well-paid jobs in the financial sector, more work for support staff, lawyers and accountants, and more business meetings creating employment in the hotel, communications, restaurant and catering sectors. This activity can bring both wealth and valuable tax revenues to a jurisdiction. Additionally, as government debt levels increase, governments have the greatest incentive to raise money in the capital markets as inexpensively as possible. If a government inefficiently regulates capital markets, the markets will be beset by a combination of high costs, non-transparency, and low liquidity; all of which mean that the government will have to pay more to borrow money.

1. The Cost of Not Competing

In the modern world, there is no reason why currency, shares or bonds have to be traded in the local currency. The currency itself is merely a unit of account. Moreover, there is no reason why trading has to be done either on the local market, or on any "market" at all. Since the mid-1980s there has been a strong trend away from floor-based trading toward computer screen-based trading. Screen-based trading can be done without the cost and unreliability associated with a large number of floor traders or back office workers who need to match orders

⁴⁵⁴ Commodities include oil, metals, textiles, and foodstuffs. Services include futures and options, interest rates, market indices, shipping, and insurance. For an indication of what types of services might be considered types of money see P.M. Johnson, "Next Growth Area: Futures on Services", *Futures: The Magazine of Commodities & Options* (June 1987) pp. 12-14.

⁴⁵⁵ In addition to the arrests and convictions of many high powered investment bankers, the United States government sent federal agents to investigate market manipulation on the floors of the Chicago exchanges. The British government has exposed market manipulation by the executives of the struggling London Futures and Options Exchange. N. Bray, "London's FOX Struggles to Adapt to a Changing Market", *Wall Street Journal Europe* (October 23, 1991) p. 13.

and fill out forms. Because the market is not tied to people who need to eat, sleep, or take holidays, the markets will in the future be open twenty-four hours a day, 365 days a year.

Companies have traditionally been listed on their local or national bourse. In an internationally competitive environment, companies have to raise (equity) capital as cheaply as possible. One way to ensure this is to list on more than one bourse. This has become easier to do. The New York and American stock exchanges list 175 non-American based companies. Additionally, 838 non-American companies have their shares traded in the form of American Depositary Receipts (ADRs).⁴⁵⁶ Each ADR represents a certain number of a company's common shares. All of the transactions are carried out in dollars. The London Stock Exchange's automated Quotron system is an electronic marketplace of all major shares which trade in Great Britain, as well as more than 600 other non-British companies.⁴⁵⁷ Going even further, the Chicago Board of Trade, the Chicago Mercantile Exchange and a publicly owned British company, Reuters Holdings PLC, have developed a screen-based futures and options exchange called Globex for after-hours trading. After-hours trading adds liquidity to the market and reduces risk. So far the Paris exchange has already signed up and negotiations are going forward with the London, Sydney, Singapore, Frankfurt and Osaka options and futures markets. Another exchange system is being developed by the Chicago Board of Options Exchange, the American Stock Exchange and the Cincinnati Stock Exchange and Reuters.⁴⁵⁸ There is no real reason why *any* stock exchange will have to exist in the future: computers might well be able to match buy and sell orders faster, cheaper and more skilfully than floor-based traders. This is one of the reasons why we have seen so many redundancies in the financial markets over the past few years. There is no reason to suppose that this trend will not continue.

With better and more powerful computers and applications looming on the horizon, the costs of not having competitive market rules will be devastating. The exchanges either have to be competitive now or the future will pass them by in favour of other locations. The costs of not being competitive will be borne by firms seeking to raise capital and governments themselves. Firms operating in a competitive international market need to have access to operating capital in the form of either debt or equity at internationally competitive rates. Governments which are the largest issuers of debt instruments need to borrow money at the cheapest rate possible or face the wrath of increasingly hostile taxpayers. Governments also risk losing a tax base. The increased cost of government actions will not be borne by international investors: they have choices where to invest money and will generally only invest in the market and in the securities which offer them the highest rates of return at a given level of risk on an *after-tax* or *after-cost* (net) basis. The cost of not competing is to send the potential investors and borrowers to other markets. One only has to look to Europe to see examples of (formerly) non-competitive markets which are scrambling to modernize.

Germany, for instance, is an industrial and economic giant but a stock market pygmy. While the market capitalization of the London stock market is 83% of the gross domestic product, the market capitalization of the Frankfurt exchange is only 21% of the German GDP.⁴⁵⁹ Until recently, German stock exchanges were a typical example of provincialism. Under pressure of world markets, there have been some attempts to change

⁴⁵⁶ L. Malkin, "ADR Market Matures in Line with Globalization", International Herald Tribune (November, 30, 1991) p. 16.

⁴⁵⁷ C. de Aenlle, "ADRs Aid the World's Traders", Global Banking and Finance Special Report - International Herald Tribune (October 16, 1991) pp. 11-12.

⁴⁵⁸ M. Baker, "Globex System Plugs Gaps in Futures and Options", Global Banking and Finance Special Report - International Herald Tribune (October 16, 1991) p. 12.

⁴⁵⁹ M. Bose, "Angst and Pygmies in Paris and Frankfurt", 43 Director (January 1990) pp. 38-42.

this.⁴⁶⁰ Even with its recent modernization, not everyone is convinced that the German stock exchanges can change sufficiently for Germany to become a financial centre.⁴⁶¹

The companies on the Paris Bourse represent just 26% of French GDP. The French financial officials are haunted by the fear that they may fall behind London, New York, and Tokyo and have made some significant reforms.⁴⁶² Even so, about 30% of Paris' main stocks are now traded in London. This has led Paris to again modernize its trading rules - a move which has taken place only three short years after Paris' version of the big bang.⁴⁶³

If a national exchange is not competitive, shares can trade elsewhere. The value of shares traded internationally is large and growing. London is the largest source of foreign equity turnover. In 1991, about \$250 billion of foreign equities were traded there. As a bases of comparison, all eight German bourses turned over about \$10 billion, while less than half the German amount was traded in Paris.⁴⁶⁴ One third of the trading in blue chip German shares currently takes place in London.⁴⁶⁵ German attempts to merge its eight regional bourses into a single 'Deutsche Börse' have so far been opposed by the Länder.⁴⁶⁶ In 1991, Germany finally decided to compete on more equal terms by dropping its dealing fees.⁴⁶⁷ London is about to drop its fees and Paris will probably halve its fees in the near future.

⁴⁶⁰ The most recent proposals may be the most far-reaching. A comprehensive plan to dispel the widespread scent of scandal was proposed at the beginning of 1992 by German Finance Minister Theo Waigel. He hopes to make German markets more competitive by reducing transaction costs, and increasing market transparency, liquidity and security. Under the plan, insider trading would be an offence punishable by up to two years' imprisonment, make listed companies treatment compatible with international rules of conduct and prompt a merger of Germany's eight exchanges. The regional exchanges and the Bundesbank have expressed reservations over the Waigel plan. C. Parkes, "Germany Plans Shake-up of Stock Markets", *Financial Times* (January 17, 1992) p. 1 and D. Waller, "Dispelling German Scent of Scandal", *Financial Times* (January 17, 1992) p. 2. One day after the Waigel plan was released, the Frankfurt stock exchange announced that it was seriously considering moving to screen-based trading. D. Waller, "Frankfurt Considers Electronic Trading", *Financial Times* (January 18, 1992) p. 22.

⁴⁶¹ In November, 1991, the German Finance Ministry announced that it was going to reimpose a 25% withholding tax on interest income effective January 1, 1993. Even though the rate of the withholding tax is considerably higher than Germany's ill-fated 1989 attempt to impose a 10% withholding tax, the current proposal was seen by the market to be a vast improvement. It is an improvement because it exempts all non-German residents from the tax, provides a 4,000 mark deduction for single individuals and 10,000 mark exemption for married couples, it is less bureaucratic and upholds German bank secrecy. T. Roth, "Bonn to Unveil Basic Points of New Tax", *Wall Street Journal Europe* (November 12, 1991) pp. 11, 13. How large a share of the market will shift to Luxembourg this time is yet to be seen.

⁴⁶² Supra note 8.

⁴⁶³ France's turnover tax provided the treasury with about \$350 million in 1990. W. Dawkins, "France Presses on with Liberalization", *Financial Times* (September 26, 1991) p. 27.

⁴⁶⁴ "Setting Europe's Stock Markets Free", *The Economist* (September 7, 1991) p. 18.

⁴⁶⁵ "Sweeping Out the Stables", *The Economist* (August 31, 1991) p. 13.

⁴⁶⁶ K. Campbell, "European Bourse Reform: Plans to Centralize Provoke Old Squabbles", *Financial Times* (October 11, 1991) p. 24.

⁴⁶⁷ "European Futures and Options: Derivative Diplomacy", *The Economist* (September 21, 1991) pp. 98-99.

In 1988, the European Commission reckoned that the cost of financial services would fall between 7% and 26% if the market for these services was truly competitive.⁴⁶⁸ Even though a stalemate on an European Community-wide Directive on Investment Services has insured that the end of 1992 deadline for creating a single European market will be breached,⁴⁶⁹ the increased internationalization of markets should eventually lower this differential to zero, with or without government action.

2. The Empires Strike Back

Many of these changes in European exchange rules were brought about to strike back at the Americans who were the forerunners and are regarded as the leaders of market deregulation. The increased competitiveness of the world's bourses has brought results. The American exchanges' share of the global futures market fell from 70% in 1989 to 67% in 1990, and their share in options dropped from 66% to 59%. The European exchanges further expanded in 1991. Deregulation and changing tax regimes will allow more institutions to make greater use of futures and options.⁴⁷⁰

In addition to fighting against the United States, continental stock exchanges obviously want to win back some of the international trade in European shares from London. However, many European exchanges are not yet sure whether to compete with each other or cooperate. Increased cooperation and a unified system would enhance liquidity, provide economies of scale, and counter the pressures of screen-based trading systems. But the different visions of the exchanges and the separate settlement systems in each domestic European market are hurdles. While European exchanges are working towards linked settlement systems, private-sector clearing houses are already approaching this goal. This provides another problem for the exchanges; their own members have a large incentive to find cheaper and simpler solutions to avoid paying fees to use an expensive and cumbersome bourse. Not surprisingly, other international linkages are being planned.⁴⁷¹

Currently, European bourse chiefs are discussing a pan-European stock market,⁴⁷² and London's automated and paperless International Stock Exchange could play a leading role in its creation. In the first quarter of 1990, daily average trading volume in international stocks in London reached \$2.5 billion; nearly 2/3 of that international volume was in European blue chip stocks, and 50% of that was in German equities. Share volumes in London in 1990 were more than three times as big as the turnover in either Frankfurt or Paris.⁴⁷³ However, the heads of the continental exchanges resent the London exchange as a threat to their own supremacy in trading domestic stocks. The London exchanges' dilemma is whether to cooperate with its continental rivals or, building on its own strong base, bid on its own to become the future Eurobourse.⁴⁷⁴ London still has to compete with New York and Tokyo. For example, competition from futures markets in New York has prompted

⁴⁶⁸ "Struggling Through the Wire", The Economist (August 3, 1991) p. 65.

⁴⁶⁹ "EC Fails to Agree on Pact For Investment Services", Wall Street Journal Europe (December 17, 1991) p. 15.

⁴⁷⁰ "Europe's Futures and Options", The Economist (March 16, 1991) p. 79.

⁴⁷¹ "Plugging into a Pan-European Stock Market", The Economist (March 10, 1990) pp. 81-82.

⁴⁷² Better established markets have been taking measures to stop this from happening and Denmark, Luxembourg and Ireland suspect that the more established markets are insisting on tighter controls to prevent the relative newcomers from attracting business through their looser regimes. C. Moir, "Markets Short on Accord", International Management (September 1991) pp. 64-66.

⁴⁷³ *Ibid.* at 66.

⁴⁷⁴ C. Makin, "London: Bickering Over a Eurobourse", 24 Institutional Investor (July 1990) pp. 190-193.

changes in the way London's futures markets for soft commodities - cocoa, coffee, and sugar - do business.⁴⁷⁵ London's exchanges are facing competition from Paris, the London-based international arm of the US over-the-counter National Association of Securities Dealers Automated Quotes, and the Federation of German Stock Exchanges. Efforts to buttress London's position place a high priority on sorting out its settlement system.⁴⁷⁶ At this time it is not clear whether London will remain the centre for international equities. Continental bourses are reforming and automating, and, as more efficient exchanges develop overseas, London's screen-based system may lose some of its appeal.⁴⁷⁷

There is some question whether the battles between organized stock markets will make much difference. As much as 43% of equity trading in Europe does not take place on a stock market at all - it takes place on computer screens. This has led all bourses to become more efficient and competitive. While attempts to create a pan-European exchange are continuing, the planned joint venture between various national bourses, Euroquote, was scrapped because of fundamental disagreements regarding its purpose and a fear that London would dominate European equity trading under this system.⁴⁷⁸

a. Paris and Frankfurt

Unless and until a pan-European exchange is established, competition will remain fierce. The Paris financial futures exchange is battling the London exchange for domination of European futures trading. Both are launching new products and services. London enjoys the support of active currency markets and London's international financial presence, but it has recently lost business to Chicago's after-hours exchange. In addition, London was forced to cancel its ten-year British debt contract because of a lack of supply, and Frankfurt is threatening to take away the futures trading in British debt contracts. In order to compete with the American bourses, London lengthened its trading day by introducing an after-hours automated trading system in October 1989. Paris has so far attracted fewer participants than it hoped, but plans to broaden its appeal by moving into non-franc products and participating in a Chicago-based after-hours electronic trading system. Observers worry that the growing competition will reduce liquidity.⁴⁷⁹ Both London and Paris grew at a staggering pace in the 1980s. The two rivals competed directly for the first time in 1989 in the launch of a three-month Euro-mark future. The next area of competition will be in European currency unit (ECU) interest rate futures and Italian government debt.⁴⁸⁰ Because of the thinness of the ECU market, the two exchanges will issue contracts of different maturities and have agreed to discuss any future plans with each other and to set up cross-listing and cross-clearing arrangements. The London market will become the first major futures market to introduce an after-hours screen-trading system, while Paris has agreed to list its products on Chicago's similar system. Competitive pressures may hit London harder than Paris because, a coming German exchange will doubtless cut into the mark-denominated contract business - on which London relies heavily.⁴⁸¹

It is possible that, in the foreseeable future, the German futures and options exchange, and the Paris exchange will catch up with and perhaps even overtake London. Germany has both the key European currency and the

⁴⁷⁵ The system, which electronically matches buy and sell orders, is inexpensive and has pulled trade from the Paris market. The FOX introduced automation to several other contracts in 1989, in order to encourage overseas traders to use the London based market. "London Could FOX Them All", The Economist (December 3, 1988) p. 87.

⁴⁷⁶ N. Jordan, "The Emperor's New Clothes", Banker (May 1990) pp. 16-21.

⁴⁷⁷ S. Brady, "Some Joy in Euro-Equities at Last", Euromoney (May 1989) pp. 123-131.

⁴⁷⁸ R. Waters, "Bourses Build up Defences", Financial Times (September 24, 1991) p. 25.

⁴⁷⁹ J. Lewis, "The Euro-Futures War", Institutional Investor (March 1990) pp. 129-135.

⁴⁸⁰ "Matif in Italian Contract Move", Financial Times (October 11, 1991) p. 24.

⁴⁸¹ N. Wilson, "Capital Markets: Situation Fluid", Banker (December 1989) pp. 22-25.

strongest economy. In addition to the high financing power of Germany's universal bank system, numerous factors have seen Frankfurt emerge as Germany's leading financial centre. Frankfurt hosts more than 400 credit institutions employing in excess of 42,000 people, one-third of them in the securities business. About 70 foreign banks are registered members of the Frankfurt Stock Exchange. In a wider context, Germany's high standing within the international financial community should be considered. Overall, if Germany adheres to its current pension provision system, Frankfurt could become the financial centre for fixed-income instruments and London could retain its status as the most important financial centre for equities.⁴⁸² Paris is already the top financial centre in Europe for a number of financial instruments.⁴⁸³

b. Copenhagen and Stockholm

In Denmark, a campaign has been undertaken to turn Copenhagen into an international financial centre. To accomplish this goal, the Copenhagen Stock Exchange was reformed by adding day-long decentralized trading with computerized price changes and paperless shares.⁴⁸⁴

In 1990, 45 per cent of turnover in Swedish equities was conducted outside of Sweden. The first act of Sweden's non-socialist government was to abolish the one per cent turnover tax on share trading. Sweden, which enacted a 1% turnover tax in 1984, and doubled it in 1986, found that turnover increased 25% when it reduced the turnover tax at the beginning of 1991. In 1990, 45% of all trading in Swedish shares was done outside Sweden. In October, 1991, the newly elected Conservative government abolished the tax entirely and expects market volume to increase by a further 25% to 50%.⁴⁸⁵ Other beneficial tax changes are expected including the elimination of double taxation of profits and dividends and an abolition of capital gains on shares. Restrictions on foreign share ownership are also expected to be eliminated. The Stockholm bourse was automated in 1989. A rule against insider trading and other measures have been adopted to make the markets more transparent. Finally, the Stockholm Bourse will lose its monopoly and be privatized in 1992. These measures are expected to decrease the cost of capital of Swedish companies.⁴⁸⁶

c. Amsterdam

The Dutch capital market has been further deregulated with the introduction of a reform package designed to enhance Amsterdam's competitiveness as an international financial centre.⁴⁸⁷ The change in the operations of the Amsterdam Bourse has been dramatic. It had to be if Amsterdam was to continue to have any interest for either domestic or international investors. In 1989, more than one-half of all Dutch government bonds were traded in London. In reaction to this outflow, the Dutch stamp tax was abolished and the brokerage rules were changed. By 1991, over one-half of the listings and one-half of the volume were conducted for the benefit of foreign investors and institutions. But in part, this action was the equivalent of closing the barn door after the horses were gone: in 1991 about one-quarter of the share trading of the 20 largest Dutch companies still took place in London. Further reforms are being contemplated.⁴⁸⁸

⁴⁸² B. von Ribbentrop, "Frankfurt Throws Down the Gauntlet", *Euromoney* (October 1990) pp. 42-43.

⁴⁸³ N. Wilson, "France: Brilliant Future", *Banker* (June 1990) p. 48.

⁴⁸⁴ "European Capital Markets -- Denmark Takes a Step Towards an International Role", *Asian Finance* (September 15, 1986) pp. 104-105.

⁴⁸⁵ "Sweden Unveils Proposal to Scrap Tax on Equities", *Wall Street Journal Europe* (October 11, 1991) p. 13; R. Taylor, "Sweden to Drop Turnover Tax on Shares", *Financial Times* (October 9, 1991) p. 2.

⁴⁸⁶ J. Burton, "Sax, Sox, Tax Moves Widen Interest", *Financial Times* (October 17, 1991) p. 27.

⁴⁸⁷ "European Capital Markets -- After the Big Bang, a Whole New Ball Game in the City: A New Package of Reforms in the Netherlands", *Asian Finance* (September 15, 1986) p. 122.

⁴⁸⁸ R. van de Krol, "Confronting Overseas Competition", *Financial Times* (October 4, 1991) p. 25.

d. Luxembourg

Luxembourg's international importance is shown by its participation in public Euro-issues and the importance of its stock exchange. Luxembourg is also noted for its clearing organization which provides safekeeping, administration, and settlement of primary and secondary market transactions in international securities.⁴⁸⁹ Luxembourg has begun capitalizing on its advantages with the arrival of a large number of new mutual funds (unit trusts) and the extraordinary growth of the Luxembourg franc bond market. A lucrative private-placement bond market exists as well, but its dominance by several large Luxembourg banks is being challenged by a syndicate of smaller banks.⁴⁹⁰ The Luxembourg bourse was the first to actively list and seek ECU denominated bonds. By 1986, because of its bank secrecy provisions, 90% of ECU denominated bonds were issued in Luxembourg.⁴⁹¹

e. Other Continental European Exchanges

In 1992, the Milan bourse, Italy's largest, will finally permit the creation of firms that combine stockbroking, fund management, and financial-consultancy functions. By allowing Italian banks and foreign institutions to buy or set up such hybrid outfits, the bourse hopes to kill off the cosy cartel run by the 120 stockbrokers that work on the exchange. At present, international investors have little to choose from. There are still only about 200 companies listed on the bourse. To make matters worse, five tightly held industrial empires account for more than two-thirds of the market's capitalization.⁴⁹² Trading in the 21 Italian shares listed on London's screen-based system amounted to almost 60% of that in Milan.⁴⁹³ The Italian government has recently announced that it will refund its 12.5% withholding tax.⁴⁹⁴

In one fell swoop Switzerland eliminated its transaction taxes, launched a long awaited futures contract and a new government bond designed to increase liquidity in the fixed-income market. It passed these measures because it was thought that without reform, Switzerland would cease to be an international banking centre and most trading in Swiss shares would shift to London.⁴⁹⁵ Over the past few years Amsterdam, Madrid and Milan have all improved their competitiveness by removing taxes and investment restrictions. Belgium has lowered its withholding tax from 25% to 10% and has seen a great deal of capital repatriated. At least for the near future, Switzerland's 30% withholding tax will remain.⁴⁹⁶ Changes may be financially difficult. As late as 1988,

⁴⁸⁹ M. Blanden, "Europe: Fortress Luxembourg", *Banker* (November 1987) pp. 33-35.

⁴⁹⁰ M. Barrett, "Feather-Footed Shuffle in the Grand Duchy", *Euromoney* (July 1988) pp. 91-94.

⁴⁹¹ "Spotlight on Luxembourg: A Solid Base for the ECU", *Asian Finance* (August 1986) pp. 82-84.

⁴⁹² "Time for Change", *The Economist* (June 9, 1990) p. 81; "Italian Bourse Reform: Not So Simple", *The Economist* (July 6, 1991) pp. 85-86.

⁴⁹³ H. Simonian, "European Bourse Reform: Counting the Cost of Technological Change", *Financial Times* (October 9, 1991) p. 20.

⁴⁹⁴ S. Webb, "Italian Bonds Jump as Bank Refunds Withholding Tax", *Financial Times* (September 24, 1991) p. 32.

⁴⁹⁵ In Seaq's first 18 months of operation, it is reckoned that 14% of all transactions in the 17 largest Swiss shares and 11% of all trading in Swiss shares was already transacted in London. "Swiss Stamp Duty: Laughing, But For How Long?" *The Economist* (October 5, 1991) pp. 100-101.

⁴⁹⁶ G. Whitney, "Switzerland Takes Dramatic Steps to Put Fresh Life Into Its Financial Markets", *Wall Street Journal Europe* (October 8, 1991) p. 14.

the stamp tax contributed 8% of the Swiss federal government revenues. Not surprisingly, Swiss socialists are against the abolition of this tax and have forced a referendum on the issue.⁴⁹⁷

In 1991, Belgium reformed its market by undertaking its own "Little Bang." Stockbrokers lost their monopoly on exchange business; commissions were reduced by an average of 30 per cent; its settlement procedure was modernized; and a futures and options exchange is planned.⁴⁹⁸ On the other hand, the exchange has raised its fees to listed companies.⁴⁹⁹

Spain had a major reform of its markets in 1989. Competition was intensified. Fixed commissions were abolished. A fast, centralized settlements system was introduced. A strict regulatory regime was instituted; market overseers levied over \$4 million worth of fines against brokers in their first two years of operation. As a result, the markets undoubtedly became more transparent. Spain does, however charge a type of turnover tax which is larger for international investors than for Spanish ones. In 1991, both foreign and domestic investors were charged a 0.25 per cent brokerage fee on transactions, while foreigners were charged an additional 0.3% settlement fee, payable to the banks. The size of the brokerage fee is expected to come under pressure, while the settlement fee is expected to disappear altogether. This will significantly decrease the cost of doing business on a Spanish exchange - and increase liquidity.⁵⁰⁰

Switzerland has been active in reforming its markets, although it still remains considerably behind other European stock exchanges. Measures have been taken to split Swiss shares which often sell for very high amounts relative to shares on other exchanges; to minimize restrictions on foreign share ownership; make the market more transparent; and to lower costs. Still 20 per cent of Swiss blue chip shares are traded in London - and the percentage is increasing.⁵⁰¹

f. Dublin

With the permission of the European Community, Ireland has set up an onshore international financial capital in Dublin. The big lures for financial firms are low wages and a 10% corporate profits tax until 2005, a ten year exemption from property taxes or a double deduction of rental costs if the property is leased, and full deduction for capital costs. Investors who filter their investments through Dublin pay no withholding taxes or capital gains. Life insurance and pension trusts also benefit from these tax breaks. So far over 170 companies, who are committed to hiring at least 2,700 people by 1994, have applied for licences. Most of these companies are involved in fund management and administration, life assurance, asset financing and captive reinsurance. No firms are licensed unless they commit themselves to employing a minimum of 10 persons; this is to prevent firms from using Ireland simply to receive tax advantages.⁵⁰²

⁴⁹⁷ Supra note 44 at 21.

⁴⁹⁸ A. Hill, "Little Bang a Blow to Small Brokers", Financial Times (October 25, 1991) p. 26.

⁴⁹⁹ "Listing Rules Get Review in Brussels", Wall Street Journal Europe (October 28, 1991) p. 11.

⁵⁰⁰ P. Bruce, "Downside Emerges After Fairy-Tale Beginning", Financial Times (October 23, 1991) p. 25.

⁵⁰¹ M.R. Sesit, "Swiss Stock Market Takes Steps to Lure Investors from Abroad", Wall Street Journal Europe (October 16, 1991) pp. 9, 20.

⁵⁰² S. Laurie, "Keeping Dublin Clean", The International (September 1991) pp. 69-72. As an OECD country, Ireland offers special advantages for the Japanese which offshore financial centres cannot. The Japanese are prevented by their Ministry of Finance from investing in non-OECD countries. As a result, most of the largest Japanese financial companies and conglomerates have already set up operations in Ireland.

With all these tax advantages, one might think that Dublin is just another tax haven. This would be a mistake.⁵⁰³ Dublin has many competitive advantages which would tend to make it a financial centre: modern legislation⁵⁰⁴ and infrastructure, rigorous supervision and plentiful skilled labour.⁵⁰⁵ These are the exact qualities needed to compete in the brave new world of international finance. Unlike Luxembourg, Ireland does not offer bank secrecy. One should look at Ireland as a progressive modern financial centre: its tax advantages and incentives signify that Ireland is at the leading edge of the spiral towards lower capital taxation. It is the combination of significantly lower taxes, adequate regulation, low rents, lower labour and transaction costs, and attractive supply-side law which will accelerate Dublin toward becoming an international financial centre.⁵⁰⁶

g. London

London is taking this revamped competition seriously. Facing competition from Amsterdam, Paris, Chicago and Frankfurt, its market for financial futures has merged with its options market. From its beginnings in 1978, the market was handicapped by its under-capitalization and high stamp taxes. Along with the merger of the exchanges, the British government announced that the resulting exchange would be exempt from both stamp duty and the stamp duty reserve tax. In addition, the advantages of some of the largest market makers will be diluted, thus making the markets more transparent. At first the exchange will be floor-based, but provisions have been made to turn the exchange into a screen-based one.⁵⁰⁷

h. The United States

Increased competition from Europe has led to increased competition in the American markets. Cost considerations, technological advances, vast industry changes, and a decline in industry profitability have created new rivals for New York's position as the world's leading financial centre. New York City is concerned that both Tokyo and London are contesting New York's international dominance. Los Angeles and Chicago have emerged as domestic financial power centres. A New York City Task Force has recommended that New York join with

⁵⁰³ The Germans are very concerned that Dublin should not be used as an onshore tax haven. The German government has been told that it could lose up to £250 million in potential tax revenues from German companies' establishing operations in Dublin. Even though Dublin's tax advantages were approved by the European Commission, and there is a German-Irish double tax treaty, Germany has threatened a law to tax all German companies on the results of their overseas subsidiaries, regardless of their location or purpose. J. Maher, "On Borrowed Time", *Financial Times* (November 1, 1991) p. 18. As will be discussed below, most "German companies" would try to avoid being "German Companies" if this law were to take effect.

⁵⁰⁴ For example, Ireland was the first country to implement the European Community Directive on UCITS (Undertakings for Collective Investment in Transferable Securities), in 1989. This provides for mutual funds (unit trusts) to be marketed freely throughout the European Community. Ireland's former law on the subject barred funds from holding more than half of their securities in non-Irish companies. Currently only Luxembourg and Gibraltar offer UCITS. D. Turner, "Opportunity Knocks for the Rock", *The International* (June 1991) pp. 25-30.

⁵⁰⁵ It is estimated that the cost of doing business in Dublin is half the price of doing business in London. Not only are rents much lower, salaries are more than 20% lower. "Baring All", *The International* (September 1991) pp. 72-74.

⁵⁰⁶ The Isle of Man, for example has lowered its tax rate for fund management from 20% to 5% effective April, 1992. This compares with 20% for the islands of Jersey and Guernsey. Future drops in tax rates are anticipated. S. Stuart, "Isle of Man Seeks to Become European Leader", *Financial Times* (October 1, 1991) p. 12.

⁵⁰⁷ T. Corrigan, "Liffe Merger Improves Outlook for Equity Options", *Financial Times* (October 29, 1991) p. 27; N. Behrmann, "Liffe, LTOM Plan to Merge in 3 Months", *Wall Street Journal Europe* (October 29, 1991) p. 13.

the private sector to (1) build a long-term program to educate the city workforce of the future and to provide child care facilities; (2) constantly improve the telecommunications infrastructure; and (3) develop a more equitable system of taxation. The quality of entry-level workers must be improved and the tax burden must be decreased. It also recommends that tax provisions that discriminate against service industries should be eliminated, business taxes be reduced, and city and state tax administration be simplified and rationalized.⁵⁰⁸ In short they are asking for modern taxation and efficient government: low capital taxation, efficient background laws and a good infrastructure.⁵⁰⁹

Section 2: Company Law

In Chapter 6, two of the types of supply-side laws outlined were holding companies and company laws. As governments' ability to tax capital is reduced and the rates of capital taxation become lower and lower, the need to operate under a holding company will lessen. As this happens the distinction between a holding company and an "ordinary" parent company will blur. When this is taken in conjunction with the problems of figuring out what the 'nationality' of many companies is,⁵¹⁰ companies will have to go back and determine what efficient law is now that tax minimization is a less important corporate decision. Without tax considerations, the advantages and disadvantages of various company laws will become transparent and less distorted. The choice of a corporate operating structure will increasingly centre on finding a constitution which provides sufficient safeguards for all interested parties, minimizes transaction and agency costs, and provides surety of outcome. Because of divergent national economic styles, no one type of holding company law will suffice.

1. Why Company Laws are Supplied

As stated in Chapter 2, the general goal of company law is to find suitably efficient organizational forms for all types of economic activity. There are two strong incentives for firms to organize within an efficient company law structure. First, entrepreneurs have a strong financial incentive to organize their firms in ways which optimize resource allocation. Second, in a competitive market, firms operating under a less efficient organizational form will be put at a competitive disadvantage, making them less likely to have large scale success and more likely to fail.⁵¹¹

It is in the strongest interest of governments to provide efficient forms in order to promote efficient resource allocation and to discourage bankruptcies and dislocation. Efficient resource allocation promotes economic activity and will lead to increased economic development and employment. With this incentive, governments have few

⁵⁰⁸ W.A. Schreyer, "What New York Must Do to Remain the World's Financial Centre", *Financier* (August 1989) pp. 29-33.

⁵⁰⁹ British authorities are asking many of the same questions as the New York City Task Force. A panel of prominent bankers and legal authorities was set up in 1991 was assembled to come up with specific proposals on how to maintain a system with minimal legal uncertainty while at the same time avoiding the constrictive results of over-regulation. N. Bray, "U.K. Panel Seeks to Eliminate the Legal Pitfalls That Baset The City", *Wall Street Journal Europe* (February 17, 1992) pp. 11, 24.

⁵¹⁰ See R.B. Reich, "Who is Us", and "Who is Them?" 68 *Harvard Business Review* 53-64 (January-February 1990); 69 *Harvard Business Review* 77-88 (March-April 1991).

⁵¹¹ This idea was originally expounded in Adam Smith, first in *The Theory of Moral Sentiments* (1759). Reprint (Liberty Classics: Indianapolis, 1976) p. 162; and *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). Reprint (Clarendon: Oxford, 1976) p. 759. See also G.J. Stigler, "The Economies of Scale", 1 *Journal of Law and Economics* 54-71 (1958).

reasons not to provide relatively efficient corporate forms. Beyond promoting eventual bankruptcy,⁵¹² inefficient company laws may have other strongly adverse consequences.

In a world in which international capital markets are increasingly more efficient, the national interest cannot truly be served by having an inefficient set of company laws. In the absence of capital controls, investment will be made in the place where it will make the greatest return, all risks being equal. Knowing that investment flows across borders seeking the highest return, most governments take various actions to provide an attractive climate for both foreign and domestic investment. Inefficient organizational forms will necessarily create a bias against local investment. The only way in which resource allocation, economic development and employment can possibly be maximized is through the provision of efficient company laws.

All company laws try to reconcile the interests of the shareholders, the creditors and sometimes the employees and the general public. Because of differences in national economic styles, each country balances these competing interests in different ways. The diversity of company laws is generally not the result of ideological conflict, except in the cases of worker participation and the question of representing the "public interest."⁵¹³ As discussed in Chapter 1, an "efficient" balancing of these interests will occur when the total amount of utility found in society is maximized. This is precisely why company laws are better passed at a national or state level instead of at an international or pan-national level: differences in national preferences would almost certainly mean that a universal company law would not maximize satisfaction in most countries. Thus, a harmonized company law would be inefficient.

The provision of company laws has become of major importance in a world where it becomes increasingly difficult to determine the 'nationality' of any given multinational firm. Firms are established in the legal structure that most closely meets the enterprises' control and economic objectives. If that form is not available in one jurisdiction and a suitable form is only available elsewhere, using supply-side law, many firms will move as long as the business will not be negatively affected and the benefits of such a move outweigh its costs. Chapter 5 showed that contracting costs fall as technology advances. This is equally true for the cost of getting information about and forming companies, so that the cost of a move to another jurisdiction (the "exit cost") goes down.

There is an historical parallel in the freedom of American companies to establish and incorporate in any state. In the United States, a majority of the larger public companies have elected to utilize the company laws of the small, otherwise insignificant state of Delaware. While this was partially done for corporate and individual tax reasons, this is not the only reason. As firms are given the freedom to establish freely in any European Community Member State and to operate (relatively) throughout the Community, it is likely that one or more countries will compete to supply European incorporations. The winning countries will provide companies with the lowest taxation, the most efficient background law, access to a modern and efficient capital market and the best protection for the company, and its entrepreneurs and capital owners.

2. History and Background

Given this context it is useful to look at the current provision of company laws in the United States and Europe.

⁵¹² Relatively inefficient firms may not go out of business for considerable periods of time, if ever. See R. Nelson & S. Winter, *An Evolutionary Theory of Economic Change* (Cambridge: Belknap Press, 1982). This does not change the equation that firms operating under an inefficient company law are more likely to go bankrupt than firms operating under an efficient set of laws.

⁵¹³ There is some conflict as to whether the addition of codetermination and public interest provisions to company law statutes is ideologically based. Clearly these provisions were initially not the outcome of broad-based economic thought. The idea that these (primarily codetermination) provisions result in an economically efficient firm structure is a separate issue. See J. Backhaus, "Worker's Participation Stimulated by the Economic Failure of Traditional Organization: An Analysis of Some Recent Developments", in H.G. Nutzinger & J. Backhaus (eds.), *Co-Determination: A Discussion of Different Approaches* (Heidelberg, New York: Springer, 1989) pp. 229-68.

a. Europe

The large scale development of company law began with the growth of the large European trading companies of the seventeenth century. At this time the companies began to demonstrate the characteristics by which they are still identifiable today.

These characteristics include:

- (1) Economic activity as a legal or actual goal of the company;
- (2) The execution of this economic activity through the accumulation of capital from many sources;
- (3) Engagement in businesses which, by virtue of their high risk and large capital requirements, could not have been undertaken by lone individuals;
- (4) A variety of forms of company organizations; and
- (5) The need of passive investors for a mechanism through which they could safely entrust their capital to either investor-managers or professional managers.

By the seventeenth century a close relationship between the political structure in the home country and the enterprise can be found.⁵¹⁴ Often these enterprises were owned and operated by the state. Governments often granted privileges to various enterprises in order to promote both the enterprises' interests and the interests of the state by giving the company a separate legal identity and declaring the company a "legal person". This was necessary because only "persons" could avail themselves to a country's legal system. Conversely, it was important for the country, because only "persons" were subject to certain forms of taxation. The state often granted non-state enterprises a legal monopoly for their commercial activities. These governmental grants were the forerunners of modern company law.⁵¹⁵ Their major shortcomings were that there were no strict legal requirements for receiving the grants and it was an expensive process with no guarantee of eventual success.

The development of national company laws began in the nineteenth century. The rapid industrialization of the first half of the century led to the development of new company structures. By the second half of the nineteenth century the economy of the Western world had been transformed. The company laws of the time contained few of the organizational norms which are familiar today. Industrialization made economies of scale possible which led to the formation of large companies. This was particularly true in the German Reich and in the United States, and to a lesser extent in France and Great Britain.

The national governments of Europe, beginning with France in 1807,⁵¹⁶ encouraged this process by freeing the corporate structures from their historical restrictions. General provisions and normative provisions gradually replaced the case by case legislative approach. Under this new system any firm meeting the organizational conditions of the enabling statutes had a right to be constituted as a company. The states no longer retained investment supervision over companies, either by placing restrictions on a company's objectives for the protection of investors or for the purpose of generally controlling the company's economic power.

Despite the general structural uniformity of European Companies there are considerable differences in how various countries implemented their enabling statutes. Dissimilarities arose as countries reformed their statutes by adopting various protection mechanisms. This differentiation can be seen today in areas which include: statutes on the adequacy of stated capital versus fixed capital; provisions for raising and maintaining capital; provisions

⁵¹⁴ For a history of company law in Europe, see generally R.M. Buxbaum and K. Hopt, Legal Harmonization and the Business Enterprise (Berlin: Springer, 1988).

⁵¹⁵ The Netherlands, unlike other European countries, retains one of the pre-enabling statute restrictions. The Dutch Burgerlijk Wetboek, Book 2, Article 68 states that a certificate of government approval is necessary to form a corporation. This is an exception in form only, since the issuance of the certificate has become a mere formality.

⁵¹⁶ This step was followed by Spain in 1821, the Netherlands in 1838 and Prussia in 1843. Greater liberalization was unleashed by the English Companies Act of 1862.

regarding the contribution of nonmonetary capital; issuance of nonvoting shares; limitations on the validity of unequal voting shares; limitations on the company's reacquisition of its shares; requirements for capital increases and reductions; minimum contents to be contained in company charters; provisions for controlling the company; and definitions in the duty to observe these regulations.⁵¹⁷

Developments in company law facilitated growth by sanctioning external expansion and promoting capital concentration.⁵¹⁸ In Common Law countries the development of organizational law was traditionally in the hands of the courts. Even though France is a Civil Law country the courts played a similar role there since France's initial organization law was left unamended for many years.⁵¹⁹ The German legislature, on the other hand, monitored its company law and made reforms during this period. The German law was primarily intended to serve the capital interests of shareholders as it concerned itself with controlling the management by making it accountable to the shareholders.

The problems of management control were seen as fundamental everywhere, but only a few legal systems developed a truly independent supervisory body or board of directors. Various countries adopted different management structures. This will be further discussed below.

To understand the legal framework, it is helpful to consider the economic thought under which these laws were developed. The Adam Smith concept of an invisible hand, that automatically makes economic corrections for the maximum benefit for all, is not an idea which has had a great influence on continental Europe. Instead, continental Europe has been greatly influenced by Marxism and socialism on the one hand and by corporatism on the other.

Roman Catholic social thought has emphasized corporate and cooperative social goals and has condemned the purely materialistic values of the market place. This outlook dominated postwar Christian Democratic movements in the Netherlands, West Germany, France and Italy. The Christian Democrats in turn were the most important single movement which influenced the development of the European Economic Community. A secular corporatism was also part of fascist thought of the 1920s and 1930s. The great state corporations of modern Italy were established under the fascists. Spain and Portugal were greatly influenced by Catholic and fascist corporatism as well as by Marxism and anarchism.

Europe itself, as a community, can be viewed as a corporate undertaking. Jean Monnet's postwar plan to put the French and West German coal and steel industry under a common public authority was the foundation for what has turned out to be the European Economic Community.⁵²⁰

b. The United States

Company law commenced in a similar manner in the United States. But, unlike continental Europe, American economic thought was not later greatly influenced by Marxism, Catholicism, fascism or corporatism.

⁵¹⁷ Supra note 63 at 176.

⁵¹⁸ The old concession system of company law was abolished in England in 1844, in France in 1867, and in 1870 in Germany. See England (1844), Joint Stock Companies Act 1844, 7 & 8 Vict., c. 110; France (1867), Loi No. 15,328 sur les Sociétés, du 24 juillet 1867, arts. 21 & 47, *Bull. des Lois*, No. 1513, Tome 30, p. 95 (1866-1870); Germany (1870), Gesetz betr. die Kommanditgesellschaft auf Aktien u. die Aktiengesellschaften vom 11.6.1870, BGBl. Norddeutscher Bund 1870, 375.

⁵¹⁹ J. Paillusseau, *La Société Anonyme, Technique de L'Organisation de L'Entreprise* (Paris: Moreille, 1967) p. 153.

⁵²⁰ W. Pfaff, "A Cross-Channel Joust With Overblown Words", *International Herald Tribune* (October 25, 1988) p. 6. One could also view the formation of the EEC as an outgrowth of the Benelux Treaty.

Notwithstanding the invasive growth of regulation by the federal government through the federal security laws in this century, company law is still exclusively the domain of the states. While no two state company laws are identical, they are substantially similar. Innovations in one state's company law are generally quickly adopted in other states.⁵²¹ The revision process is analogous to market competition, in which states compete with each other to provide a product, corporate charters, in order to obtain tax and franchise revenues.

During the late eighteenth and the early nineteenth centuries, when a company in the United States wanted to be incorporated it had to go to the state law-making process. Incorporations were granted on a case by case basis through independent acts passed by state legislatures and signed by the state's governor. The first departure from legislative chartering of corporations came from a 1811 New York Statute.⁵²² The advantage of this type of law is effectively laid out in the following contemporary analysis:

There is nothing of an exclusive nature in this statute; but the benefits from associating and becoming incorporated, for the purposes held out in this act, are offered to all who will conform to its requisitions. There are no franchises or privileges which are not common to the whole community. In this respect, incorporations under the statute differ from corporations, to whom some exclusive or particular privileges are granted. The only advantages of an incorporation under the statute over partnerships... [derives from] a capacity to manage the affairs of the institution, by a few select agents, and by an exoneration from responsibility beyond the amount of the individual subscriptions.⁵²³

Unfortunately this ground-breaking statute was ineffectual because it was not exclusive and did not provide sufficient flexibility in terms of duration, purpose or capitalization to be useful. As a result, most corporations continued to be formed by special legislative charter in New York.⁵²⁴

Over the next 64 years, there were various improvements devised by various states. But a truly detailed modern enabling act was not passed until 1875, when New Jersey actively decided to compete for the businesses that were prospering, yet hampered by the laws in nearby New York.⁵²⁵ New Jersey's bid was largely successful. Over time further modernization occurred and now virtually every state has adopted the New Jersey type of law. The New Jersey approach has been adopted in the Model Business Corporation Act.⁵²⁶

⁵²¹ See R. Romano, "Law as a Product: Some Pieces of the Incorporation Puzzle", 1 *Journal of Law, Economics and Organization* 225-53 (1985); and D. Shughart and R.D. Tollison, "Corporate Chartering: An Exploration in the Economics of Legal Change", 23 *Economic Inquiry* 585-603 (1985).

⁵²² 1811 N.Y. Laws 67.

⁵²³ *Slee v. Bloom*, 19 Johns. Cas. 456, 473-74.

⁵²⁴ S. Livermore, *The History of Early American Land Companies - Their Influence on Corporate Development* (New York: New York University Press 1939) at 270-71. In commenting on the ineffectiveness of the early incorporation statutes, at 260-61, Livermore wrote that "...corporation primacy was threatened by the growing tendency by state legislators to impose disabilities on the corporation even while they continued to grant those particular legal advantages which set it apart from the association.... That the leading legislatures should have embarked on this restrictive policy after 1800 seems to have been due fundamentally to a recurrence of familiar 18th Century fear of the corporation's monopoly position".

⁵²⁵ J. Cadman, *The Corporation in New Jersey* (Cambridge: Harvard University Press, 1949) pp. 174-80. While New Jersey provided the first modern incorporation statute, it should be noted that 24 states beginning with Connecticut in 1837 had previously passed general incorporation laws. Of these 24 states, 13 had to amend their state's constitution to do so.

⁵²⁶ ABA Committee on Corporate Laws, *Model Business Corporation Act Annotated*, Third Edition, (St. Paul: West Publishing, 1986).

Delaware became home to over half of America's largest corporations as a result of supplying laws in which its courts have regularly handed down decisions that affirmed the actions of corporate boards as long as the decisions were made in good faith (this basis of these decisions is now called the "business-judgement rule"). Beginning in 1913, New Jersey lost its preeminence due to Governor Woodrow Wilson's shortsightedness. At this time, Wilson began to tax companies that were incorporated but not legally based in his state. New Jersey never recovered its preeminence.

Delaware's preeminent position came under pressure in 1985, as a result of several lower courts overturning the business-judgement rule. Unlike New Jersey, this pressure proved to be temporary, since the state Supreme Court quickly reversed the lower courts' decisions, thus preserving Delaware as the America's incorporation site of choice.⁵²⁷

Probably the best reason for close approximation of the various state's incorporation laws is the fact that as long as a corporation can choose its governing law by selecting its state of incorporation, attempts at stringent control are in vain. The U.S. experience contains an important lesson for post-1992 Europe: as long as people, goods, services and businesses can operate relatively freely, they will gravitate to the place that imposes the fewest restrictions, taxes and costs on their activities.

3. The Future of Europe in Light of America's Experience

Like post-1992 Europe, the United States is a common market where goods are freely traded from state to state. Each state has wide latitude to pass the company laws and state tax laws of its choosing. While there is a more important common national corporate tax structure with higher corporate tax rates, the states have separate corporate tax policies. Although the federal government arguably has the capacity to pass national company laws, it has only chosen to take jurisdiction over a few elements of company law, such as securities regulation.

To economists it cannot be surprising that states have entered into competition to attract corporate charters, jobs and tax revenues. One of the obvious winners, with the corporate charters of over half of the largest companies and many smaller companies, is the otherwise insignificant state of Delaware. Delaware won the race for corporate charters for three distinct reasons: a liberal set of company laws, liberal corporate tax laws, and a first mover advantage.⁵²⁸

⁵²⁷ "The Delaware Court", *Corporate Growth* (May/June 1989) pp. 42-43. For a more in depth look at the incorporation history of Delaware and New Jersey see C. Grandy, "New Jersey Corporate Chartermongering, 1875-1929", 49 *Journal of Economic History* 677-92 (1989); H.G. Manne, "Intellectual Styles and the Evolution of American Corporation Law", in G. Radnitzky and P. Bernholz (eds.), *Economic Imperialism: The Economic Approach Applied Outside the Field of Economics* (New York: Paragon House, 1987) pp. 219-41; C.W. McCurdy, "The Knight Sugar Decision of 1895 and the Modernization of American Corporation Law, 1869-1903", 53 *Business History Review* 304-42 (1979). At 677-79, Grandy also notes that New Jersey adopted a liberal company law in order to attract incorporations from the state of New York. The New Jersey legislature considered its supply-side law to be an exchange of a liberal incorporation law for incorporation fees and franchise taxes.

⁵²⁸ Those who strive to stay ahead of a curve are said to have a "first mover advantage". American companies take Delaware's first mover strategy seriously. Delaware is often the first to innovate, but even when it is not first, it often quickly adopts advantageous changes which competing states make. Companies have a reasonable assurance that, if they choose to incorporate in Delaware, the state will retain its advantageous tax and company laws. Any innovation made by a state without a first mover advantage will have little real impact on the market. The first mover advantage takes on a special significance in the European context. Should the European Community choose or find it necessary to harmonize its company and tax laws, companies that wish to remain 'European' will be 'frozen' in the places where they were incorporated at the time of the harmonization. They will be frozen because internal EC reincorporation will not pose any benefits, but will involve an exit cost.

Delaware has the most liberal and continually innovative company law policy. Activities which occur outside the state are not taxed. Companies are attracted by Delaware's reputation and commitment to remain an innovative, low tax state. Delaware caters to a corporation's need to make business transactions flow efficiently, quickly and with maximum protection for officers and directors. Delaware has long recognized that the adoption of a comprehensive anti-takeover plan is beneficial and appropriate in many circumstances, and the state has established comprehensive guidance on what is permissible. Delaware law allows for the elimination of preemptive rights and cumulative voting rights. Delaware also offers advantages in restructuring, simplicity, and flexibility.⁵²⁹ As a result, Delaware receives about 17 per cent of its state revenue from incorporation fees. The average for the other 49 states is 1.5 per cent.⁵³⁰

4. The Delawarization of Europe?

In light of the income which Delaware receives from its incorporation law, it would not be surprising if a small European country which has designs on becoming a major financial centre, such as Luxembourg or Ireland, tries to become "The Delaware of Europe".

Like the federal government of the United States, the European Economic Community has the power to pass uniform tax and company laws and indeed has made some progress in making certain aspects of European company laws uniform.⁵³¹ The main objective of 1992⁵³² is to achieve a common market for companies by establishing similar guarantees for stockholders, creditors and employees.

⁵²⁹ S.A. Huggins, "Advantages of Incorporating in Delaware", ABA Banking Journal (October 1986) pp. 120-122.

⁵³⁰ Supra Romano, note 70. For further information regarding the fiscal effects of supply-side incorporation law and services for Delaware see E.D. Craig, "State Finances: Delaware as a Case Study", 6 Public Finance Quarterly 513-24 (1978); M.R. Brans, "The Delaware Corporation Franchise Tax: An Underexploited Quasi-Tax", 14 Marquette Business Review 24-47 (1970).

⁵³¹ There have been some considerable, if limited successes in this area. With a few holdouts on laws regarding accounting procedures (the Fourth Directive) and disclosure requirements (the Seventh Directive), all of the EEC countries have adopted uniform rules for company registration (the First Directive); basic standards for capital formation and maintenance of public companies (the Second Directive); procedures for mergers of public companies (the Third Directive); procedures for the divisions of public companies (the Sixth Directive); and uniform standards for auditor qualifications (the Eighth Directive). This so-called harmonization can be vague. The Fourth Company Law Directive, 78/660/EEC, leaves "No less than 41 options open to the Member States in addition to the 35 options left to the members themselves". Supra note 63 at 235.

⁵³² Completing the Internal Market (Com(85) 310).

Under the Treaty of Rome, firms are allowed to freely establish and move throughout the Community.⁵³³ With the advent of 1992, the European Court should take this plain language of the treaty at its face value. Whether companies will be totally free to move throughout the Community as long as they are incorporated in at least one member state has been a source of some controversy.⁵³⁴ Assuming that firms are truly able to operate anywhere in the Community regardless of the place of the incorporation, the 'winning' country will supply the company law which minimizes Community-wide taxation, imposes the fewest legal restrictions and affords the highest protection and control of management and shareholder interests. In short, the country will supply a company law which will make it the "Delaware of Europe."

5. The European Debate

Legislation concerning corporate forms is a core aspect of both legal and economic policy: corporate forms determine the legal environment of production and exchange and thus crucially affect where capital is invested and the performance of the economy as a whole. The national government of the United States is not engaged in legislating corporate forms. The state-enacted corporation and partnership statutes, although similar in philosophy, vary from state to state. While the federal government is concerned with whether companies are incorporated in the United States, it cares little about where a company is located as long as it is located somewhere in its jurisdiction so that it is not deprived of its national corporate tax revenue.⁵³⁵ In Europe the statutes are exclusively at the national level. But like individual American states, European countries should care if corporate forum shopping is done in another EC country. As discussed above, this should become increasingly likely in the context of 1992.⁵³⁶

⁵³³ Articles 52-58 of the Treaty of Rome deal with the right of companies to establish freely and move across internal EC borders. More broadly, Article 2 of the EEC Treaty states that these objectives should be binding on the Community. Initially, a Common Market was to be established and the economic policies of the Member States were to be incrementally approximated. This was expected to bring about the ultimate objectives of the EEC: harmonious development of economic activities throughout the community; a continuous and balanced economic expansion of the Community; an increase in economic stability within the Community; an accelerated rise in the standard of living; and closer relations between the states. Article 3 summarizes the specific activities designed to achieve the goals of Article 2. The most important for our purposes are Article 3(c) which calls for "the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital;" and Article 3(h) which provides for "the approximation of the laws of Member States to the extent required for the proper functioning of the common market." In 1987, Article 8A, which calls for the establishment of the internal market by 1992 was added to the Treaty of Rome.

⁵³⁴ See B. Wachter, K. van Hulle, W. Landau, J. Schaafsma and M. Raaijmakers, Harmonization of Company Law and Securities Law (Tilburg: Tilburg University Press, 1989); S.J. Berwin and Co., Company Law and Competition (London: Mercury Books, 1989); J. Dine, "The Harmonization of Company Law in the European Community", in A. Barav and D.A. Wyatt (eds.) Yearbook of European Law 1989, (Oxford: Clarendon Press, 1990) pp. 93-119.

⁵³⁵ This divergence has led to a situation where a majority of the Fortune 500 companies have been incorporated in the small State of Delaware. Few of the Delaware corporations have either major offices or factories, let alone their corporate headquarters located in the State of Delaware. This amounts to a legal quasi-fiction where a company's place of incorporation bears little or no resemblance to any meaningful economic activity.

⁵³⁶ This should be true notwithstanding that on September 27, 1988 the European Court of Justice ruled that the British Company, Daily Mail and General Trust PLC, could not transfer its central management and control to the Netherlands without winding-up and settling its tax bill as required by British law. The primary motive for the reincorporation was to sell a significant part of its nonpermanent assets and to use the proceeds to buy its own shares without having to pay British capital gains taxes. The Court ruled that Community Law Articles 52 and 58 of the Treaty of Rome and Council Directive 73/148 of 21 May 1973 do not confer an absolute right on a company incorporated under the laws of one member

In Europe, however, company law harmonization is a difficult issue for a number of reasons. European governments must contemplate what the implications of both current and harmonized company laws will be for their individual states after the 1992 project of "Europe Without Borders" becomes a reality. In this context, a vital question for managers of multi-national companies and their lawyers is: now that our company can produce goods in any EC country (hopefully with uniform standards) and can transfer capital freely, does our company want to be incorporated in Europe, and if so, where and in which form;⁵³⁷ which country supplies us with the most efficient company law taking into consideration the goals of the firm?

If European company law is not harmonized and companies can freely operate anywhere in Europe within a single structure, a situation similar to what has occurred in America is likely to occur. In America, the small and relatively insignificant state of Delaware has largely replaced New Jersey as the home of a large majority of America's largest companies. Without a uniformity of company laws within the European Economic Community, a "Delawarization of Europe" is likely to occur.

One way in which to attract firms and their capital to a jurisdiction would be to maintain low minimal standards of capital, minimal regulation, ineffective labour laws, and more importantly low taxation, while at the same time supplying high degrees of protection to capital owners from worker representation and managers from corporate raiders. The benefit to Europe's "Delaware," would come from filing fees, the employment of lawyers, accountants and secretaries and perhaps, for a small country, even some additional tax revenue. The drawback for the "winner" would be a loss of some national control over corporations, and a loss of tax revenue if Europe's Delaware was a larger country. While Ireland, Denmark and Portugal are candidates, Luxembourg would be the winner. It is by far the smallest of the EC countries. It is centrally located. It has a strong capital market. And it has a long, well deserved reputation for being a tax haven with strong bank secrecy laws. Luxembourg has preserved its bank secrecy laws, despite EC pressure to reform, because it is well aware of the economic benefits that it derives from being a tax haven. These are benefits similar to those that Luxembourg would derive from becoming Europe's Delaware.

While there have already been some major, but limited and relative, successes in company law harmonization in Europe, the governments have not yet agreed to enact European Commission proposals which strike at the heart of corporate life and its management's freedoms: directives which mandate a harmonization of corporate board structures and worker participation (the Fifth Directive), and group level legal responsibility (the Ninth Directive).⁵³⁸ These directives are undeniably social in origin, but, if adopted, will have a major economic effect. There may be good reason why they have not been adopted: they may not be efficient in either a national or international context.

The program of European company law harmonization has been a two-tracked approach based on a trade-off from the start. The main objective is to achieve a common market for companies by establishing similar guarantees

state and having its registered office in that country to transfer its central management and control to another member state. Whether this ruling absolutely stops companies from reincorporating in other countries without the consent of the countries or whether it is intended merely to stop blatant attempts at tax evasion is unclear. The Court does, however, stress that all of the states permit the winding-up of a company and its reincorporation. This would support the later view.

⁵³⁷ Companies, incorporated in the EC have, since the end of the transitional period in 1970, been free to establish across the Community's borders with limited exceptions. Article 58 of the Treaty of Rome states that: "Companies or firms formed in accordance with the law of a member state and having a registered office, central administration or principal place of business within the Community shall ... be treated in the same way as natural persons who are nationals of member states."

⁵³⁸ The EC's Council of Ministers have adopted seven of the ten Directives submitted to them by the European Commission. A directive orders each EC country's legislature to adopt enabling legislation that conforms to the orders of the directive. These measures, particularly those setting out common rules and requirements for financial reporting, have had a direct impact on companies operating in the Community and on the professions, especially lawyers and accountants, who service them.

for stockholders, creditors and employees. The trade-off is a loss of market freedom for companies through mandatory measures which ensure equivalent economic and social protection in the Community's member states. The problem lies in the fact that the goals of a free market for companies and harmonized protection for investors and workers are incompatible. Some governments, led by Great Britain, are unequivocally for a free market for companies, while others, led by Germany and the Netherlands, are anxious that incorporation statutes should contain certain social elements.⁵³⁹ At this point the economic position of the United States becomes intertwined with the position of the "free market" group.

Nowhere is this conflict more apparent than in negotiations over the Fifth Directive. The Fifth Directive was first proposed in 1972 and then resubmitted to the council in amended form in 1983. It has two main aims: A two-tier board structure and worker participation in companies with more than 1000 employees.⁵⁴⁰

A two-tier board system has a supervisory and a management board. This legally imposed structure dates back, in France, to 1856.⁵⁴¹ Under a compulsory two-tier governance structure, the management board manages the company on its own responsibility and represents the company in relations with third parties. It is not directly subject to the instruction of the shareholders, but is influenced to a certain degree by resolutions of the supervisory board. The supervisory board determines the policy of the company. It supervises the management board and appoints its members. The supervisory board may not take part in the active management of the firm and may only represent the company in transactions with the members of the management board. No person can serve on both the supervisory and management boards simultaneously.

Worker participation in the firm is a more fundamental innovation in company law. It can take one of four forms under the current 1989 EC Draft Directive: (1) the election of employee representatives to the supervisory board of a two-tier corporation or, in a single-tier system to the unitary board (in a non-executive capacity); (2) the co-option of employee representatives to the supervisory board or (in a non-executive capacity) to the unitary board; (3) worker participation through a body made up solely of worker representatives; or (4) worker participation through collective bargaining which in effect is equivalent to one of the first three. Currently, German company law mandates the first option (in companies with over 2,000 employees)⁵⁴². Danish company law mandates

⁵³⁹ These positions have been frequently articulated by European leaders while presenting their vision of a "United Europe." On September 20, 1988, the then British Prime Minister Margaret Thatcher, in the opening ceremony of the 39th academic year of the College of Europe in Bruges stated: "We have not successfully rolled back the frontiers of the state in Britain, only to see them reimposed at a European level, with a super-state exercising new dominance from Brussels....Our aim should not be more and more detailed regulation from the centre; it should be to deregulate, to remove restraints on trade and to open up....We emphatically do not need new regulations which raise the cost of employment and make Europe's labour market less flexible and less competitive with overseas suppliers." D. Marsh, "Thatcher Rails Against Europe", *Financial Times* (September 21, 1988) p. 2. German Chancellor Helmut Kohl responded on October 18, 1988 while speaking at a Catholic conference in Brussels. He reminded the audience that the goal of 1992 was social as well as economic, "Europe cannot take shape unless its citizens identify with it. That is why, for me, the social dialogue is a vital part of the living 'Europe of citizens'." S. Avery, "Kohl Reacts to PM", *The Independent* (October 19, 1988) p. 1.

⁵⁴⁰ The current draft, which began floating around on October 16, 1989 but was not published, eliminates the requirement for a two-tier structure.

⁵⁴¹ In France, a share partnership, in contrast to a corporation, had long been available without government permission. Through time it had become an instrument for serious abuse. France responded by enacting a mandatory two-tier company in 1856, but only for limited-share partnerships. M. Viander, *La Société en Commandite Entre son Passé et son Avenir*, (Paris: Etudes du Centre de Recherche sur les Droits des Affaires, 1983) at 50-53.

⁵⁴² See MitbestG 1976. The western German model is based on equal representation of capital and labour, and places a final tie-breaking vote with capital in the hands of the capital appointed chairman.

the second (in companies with over 35 employees)⁵⁴³ and Dutch company law mandates the third (in companies with more than 100 employees)⁵⁴⁴.

The notion of a single-tier company, with worker representatives in a non-executive capacity, is a compromise that has already been worked out. Under this proposal, the functions of management and supervision would be clearly defined and allocated within the board. No compromise has been reached on worker participation. Interestingly, while the British government opposes worker participation on the grounds that it is required by a legally imposed framework⁵⁴⁵, Germany is opposed on diametrically opposite grounds. Western Germany had a post-war legislative commitment to worker representation, on which the original EC proposals were largely based. All German political parties view their legally imposed two-tier companies with mandatory worker participation on the supervisory board as being central to the balance and success of Western Germany's social market economy. Germany views the current proposals as being too weak to pass as real worker participation

⁵⁴³ See *Aktieselskabsloven* 1984.

⁵⁴⁴ Work Councils are mandatory for companies with as few as 10 employees. They, unlike companies with over 100 employees, are not given the right to veto nominees to the management board. See Law of 22nd May 1981, *Staatsblad* No 416, which mandates Works Councils, and Works Council Law 1971 for the right afforded Works Councils of various sizes. The Dutch worker participation law was introduced in 1973. Under this model, the managerial board of directors, the central works council and the shareholder's general assembly each make proposals for appointments to vacant supervisory posts: the supervisory board chooses one of these three nominees.

⁵⁴⁵ It is also interesting to note that the British Trade Unions have traditionally opposed the concept of worker representation because it would largely take away the "us versus them" class issue from which they feel that their traditional strength arises.

and is afraid that the current form may eventually erode its own well proven models⁵⁴⁶. It is difficult to find an area of compromise against this setting.

Unlike other issues of company law, decisions over worker participation have not been based on technical issues of corporate organization, but involve fundamental questions about economic systems, which are often decided on the basis of emotion and ideology.⁵⁴⁷ Because of the argument linking efficient law with national economic styles made in Chapter 4, this is exactly why such issues are better settled at the national level, rather than at a pan-national level. The addition of workers' rights to company statutes considerably increases employers' obligations and potentially adds greatly to a company's bureaucracy and costs, to an extent dependant

⁵⁴⁶ Germany also feels that without company and social law harmonization it will lose a significant amount of investment to EC countries that do not have two-tier governance systems, worker representation and strict labour legislation. This indicates that Germans fear that, if German companies were free of mandatory codetermination, at least some would abolish it. It also demonstrates that Germans regard codetermination as efficient background law. Codetermination is clearly a trade-off. The chart below demonstrates that on average, the largest German firms, all with mandatory codetermination are less profitable than other large EC industrial firms. German employees also take a much higher proportion of the value added to the firm than other European workers. Value added by the firm is defined as wage costs plus profits before interest and depreciation. One would expect that over the longer term, international investors would be reluctant to invest in large German companies.

Returns and Distribution of Value Added in the 500 Largest EC Industrial Firms

Country	Number of Companies	Investor share %	Employee share %	Ratio	Profit Margins 1989 %
UK	201	8.1	60.2	7.4	9.5
Spain	10	8.1	65.6	8.1	6.0
Italy	25	7.3	64.1	8.8	6.7
Belgium	17	6.8	63.3	9.3	6.0
Holland	35	5.0	66.9	13.4	6.3
Denmark	15	4.3	69.8	16.0	5.9
France	111	3.7	69.2	18.7	6.8
Germany	81	2.7	75.7	28.0	3.6
Ireland	4	2.6	67.5	26.0	6.7

The rest of the added value is accounted for by interest, tax and retained profit. Greece and Portugal have been omitted since none of the largest 500 industrial firms are located there. Luxembourg is excluded since its sample size is only one firm.
Source: "EC Heavyweights," By Tom Lloyd in April 1991 edition of *International Management*

⁵⁴⁷ This does not imply that legislation enacted to further social values will necessarily be inefficient since social values often embody a society's experience and thereby preserve optimal arrangements that have been arrived at through the course of history by trial and error. See G. Schmoller, "The Idea of Justice in Political Economy", in *Annals of the American Academy of Political and Social Science* IV (Berlin: Springer, 1894) at 697-737.

on the form in which the workers rights are imposed. It is an open question whether the benefits of worker participation: building trust between social partners, greater company disclosure in the interest of the workers and the public, more careful decisions on basic company matters and greater social justice, outweigh its drawbacks: creation of conflicts of interest for worker representatives on company bodies, threats to business secrecy, delays in decision making and non-market influences on decisions. There is even greater uncertainty regarding the consequences of transferring a model that works in one society to a different culture with a different social and legal framework.⁵⁴⁸

It is interesting to note that both opponents and proponents of worker participation argue their case on the basis of economic efficiency and its effects on European integration. The opponents fear that worker participation will reduce the efficiency of the organization in general and in particular that national worker representatives on a board would block closures of factories in their country and the transfer of production to other Member States. Supporters argue that worker participation will promote economic efficiency by producing a less tense social climate and reducing strikes.

The implication of the previous discussion is far away from the original intent of those who first argued for a uniform European company law: to easily facilitate cross-border partnerships between businesses.

6. Implications of this Debate for Europe

Just as when New York companies moved their site of incorporation to New Jersey 100 years ago, some companies which are facing inefficient legal restrictions will "move" their charter to countries which offer a more hospitable law. This "move," in the short run, may only mean holding shareholders vote and filing an application for incorporation in a different country. As taxes become a less important determination of where a company should be incorporated, companies will increasingly look for corporate forms which lower their costs and add to their profitability. In an international capital market investors will increasingly demand the highest returns possible. One can expect that sleepy managements will have difficulty staying in power if they pay a premium for being an underachiever in the marketplace.

Economists like to construct theories that contain logical conclusions that hold true under equal conditions. No exception will be made here. The theorem of efficient law states that businesses attempt to act in ways that will lead to increased profits and control over their ability to operate and, all other things being equal,⁵⁴⁹ the capital interest of companies will attempt to incorporate in places where they have the lowest taxes (and therefore

⁵⁴⁸ Important differences may be contained in the labour law, labour conflict, worker attitudes, and trade union behaviour and influence. *Supra* note 63 at 262.

⁵⁴⁹ The condition of "all other things being equal" is an important one. Some companies lobby governments in quest of favours which are of economic benefit to them. In economics this process is commonly known as rent-seeking. Companies which receive enough governmental favours have an incentive to stay in the country where the favours are granted. These favours may include tax breaks, trade protection and preferential treatment in the granting of governmental contracts. Should these advantages disappear upon reincorporation in another country and the total value of this "economic rent" surpass the sum of the total value of the inducement for moving plus the costs expended to receive the governmental favours, a company will remain in what is an otherwise uneconomic place to be incorporated in. These inducements cost either the taxpayers or consumers money. In a Delawarized Europe this could amount to government officials "bribing" a company to stay. This would most likely be done at the request of the company. Bribery is usually thought to go in the other direction. This process will have few economic benefits for the country and should be distinguished from the case where a country offers incentives to a company not to move out its actual operations. In this case it is possible that the value of the favour to the company will be less than the amount of tax revenue which continues to be earned from the employees that remain employed, unemployment taxes collected and expenditures saved and property taxes.

the greatest net profits) and the least outside interference in their operations.⁵⁵⁰ Unlike most economic theories, the theory of efficient law is constantly being tested in the real world. The goal of the European Community is to make all relevant individual circumstances equal. If the stated goal of the 1992 programme is ever fully accomplished and the goal of a harmonized company law in the EC is not achieved, then it is relatively safe to predict that many companies within Europe will change either the place or the form in which they are incorporated. If true economic and political harmonization fails, as long as goods and services can freely pass through European national borders, firms will find it advantageous to incorporate in "Europe's Delaware" and base their European operations in the countries with the lowest costs of production, wages and benefits, and taxes and weakest unions and government regulations, unless there is a compelling reason to do otherwise. All of these conditions may not be present in one country. The greatest advantage for a company may lie in being incorporated in one country, having its major offices in a second country and its production in a third country.⁵⁵¹

To many Europeans, the implications of a Delawarized Europe are hard to imagine. Consider the shock in Germany, for example, if such well known companies as Siemens, Daimler-Benz, Bayer, Deutsche Bank and many other currently "German" companies were to begin operating under the laws of Luxembourg (or whatever country offers the "best" business climate). More than a psychological loss is at stake for the affected governments. From the standpoint of the government, there is a question of the loss of tax revenues which were formerly paid to the treasury from various types of accounting profits. There is also the paramount question of where people will be employed and pay their taxes. Without harmonization, countries must either lower their tax rates and the amount of inefficient legally imposed control over companies or face losing "their" companies.

Some of the effects of laws that impose inefficient worker participation either through works councils, which operate at the plant level, or co-determination, which operates at the company level, will be weakened if the companies relocate their incorporations. For example, The Netherlands and Germany are the only two countries that mandate a two-tier board structure for large enterprises. Under this structure, the employees have some, but not the ultimate, power to either appoint, or block nominations for membership on, the management board. If the company relocates to a country which allows single-tier companies, and single-tier companies are presumed by the shareholders to be more efficient, the management board would be formally disbanded and the power which the workers formerly held has been eliminated.

The trade unions have categorized this process as "social dumping" and they are clearly worried about it. They are naturally concerned that employers might try to undercut existing social obligations by threatening to move production to areas with lower standards. But what the trade union leaders neglect to mention is that companies have always held this option and whether or not one agrees with this practice, it is a smart and effective bargaining tool. Trade unions generally only cave into this ultimatum if they feel that the company is serious and ready to pack up and leave. With changes in technology this is even more feasible.

A much cheaper alternative for a company attempting to remain in an EC country and to evade unwanted social legislation would be to leave the factories in place and to change some of the legal conditions under which it operated. In a "Delawarized" Europe, the use of supply-side company law would mean that a simple change in

⁵⁵⁰ Transaction costs guru Oliver Williamson noted that Transaction-Cost Economics "emphasizes ex post costs. These include...the set up and running costs associated with the governance structures". "Corporate Finance and Corporate Governance", 18 *Journal of Finance* 567-86 (1988) at 572. The transaction cost approach leads firms to both the cheapest locations and most efficient operating structures.

⁵⁵¹ Today, it is possible to contemplate an "Italian company" with German shareholders raising its capital in London, getting its raw materials from Australia and its component parts from Japan, having production facilities in Spain and exporting its products to America. It is also not unthinkable to split the "Italian company" by placing its parent incorporation in Luxembourg and retaining its management (head office) in Italy. This scenario is the final possible frontier to the complete internationalization of companies. For some specific examples of this process see R.B. Reich, *The Work of Nations* (New York: Alfred A. Knopf) at 110-118.

the place of the parent company's incorporation could eliminate some types of social legislation without the need to negotiate with any affected worker and at little cost. The company would, of course, retain the right to negotiate cost reductions, and in the absence of a sufficient level of cost reductions, to take the step of moving the place of manufacture.

The concept of organizations evading legally imposed burdens is not a new idea. We have seen it happen in Europe. In Germany, in contrast to most countries including Great Britain and France, the corporate company structure has steadily lost importance, over the last two decades. The number of public companies, as well as the number quoted on the stock exchange, has fallen considerably.⁵⁵² At the end of 1990, only 545 of Germany's 2,682 public companies had shares listed on any of the eight German bourses. The capital stock of all German corporations was DM 149 billion of which only DM 62.8 billion was listed. This compares to 433,731 private companies which cannot be listed on a bourse.⁵⁵³ Implementation of economic and social policy through company law has placed greater burdens on public companies in areas such as disclosure requirements, tax burdens, and labour and worker participation laws. As a result, other less onerous forms of company structures have been adopted.

Two forms of organization have met the demand for a less burdensome corporate form in Germany: the regular private company (called a GmbH in Germany) has steadily gained ground, as has the limited partnership, the GmbH and Co. A GmbH and Co. is either a partnership, or more usually a limited partnership, in which the GmbH and its individual members are partners. If the partnership is limited, the GmbH is the general partner, with unlimited liability for the partnership debt, while its individual members are limited partners who are only liable to the extent of their agreed contributions. Since the GmbH itself has limited liability, in practice the whole partnership enjoys limited liability. There is also a tax advantage to this form of company since only incorporated companies pay corporate tax. By ensuring in the articles that only a small part of the profits is paid to the general partner, the GmbH, with the balance going to the individual limited partners, the burden of corporate tax is minimized. It is also free from the burden of publicly disclosing its accounts.⁵⁵⁴

One can see a similar development in The Netherlands. The Dutch BV, which is a private or closed company with limited liability, was introduced into Dutch company law in 1971. It has proved to be quite popular and over 45,000 previously incorporated small and medium sized public companies or NVs have been converted into BVs. Now there are over 25 BVs for every NV.⁵⁵⁵ For tax purposes the NV and the BV are treated identically. The law governing the BV is largely based on the laws governing the NV. The same criteria and total and partial exemptions governing the appointment, composition and functions of the supervisory board are applicable to both large BVs and large NVs. One aspect of the BV can largely explain its widespread popularity. The adoption of the EC's First Directive on Company Law obligates all NVs but only a few BVs to disclose annual accounts. It is interesting to note that, despite the presence of alternative operating structures, incorporation is the exception in Germany, while in the Netherlands incorporation has become the rule.⁵⁵⁶

⁵⁵² Today there are only some 100 genuine publicly held companies in West Germany. This compares with some 10,000 in the United States. *Supra* note 63 at 172.

⁵⁵³ "Creating a Competitive and Integrated Financial Center", Special Section Germany - Wall Street Journal Europe (October, 1991) p. 6.

⁵⁵⁴ In May, 1986 the EC Commission attempted to halt some of this evasion by presenting a draft proposal which would extend the Fourth Company Law Directive on corporate disclosure requirements and the Seventh Company Directive on group accounts to GmbH & Cos. This in turn has led to unusually strong protests from the German Government and businesses. As long as majority rule is not practised in the EEC, there is little chance that this directive will be accepted.

⁵⁵⁵ P.M. Storm and M.J. Ellis, "The Netherlands", in M.J. Ellis and P.M. Storm (eds.), Business Law in Europe (Deventer: Kluwer, 1982) at 444-445.

⁵⁵⁶ S. Cnossen, "The Case For Tax Diversity", 34 European Economic Review 471-479 (1990) at 474.

7. The Future of Company Law in Europe

Worker participation measures require unanimous approval in the European Community's Council of Ministers. This probably makes the adoption of a single company model virtually impossible. The *status quo* of a multitude of governance structures is the more likely scenario in the near future. If transaction costs are lowered and satisfaction is maximized by this cornucopia of laws, then this is an efficient outcome. The EC Commission has ruled out complete tax harmonization, and for the reasons given in Chapter 7, it is inevitable that some companies will move towards countries imposing lower tax burdens.

Section 3: Conclusion

We live in a world of multinational companies and increasingly global markets. Both companies and financial markets have to be regulated. Does the concept of efficient law entail that both be regulated by laws enacted at the same governmental level? The answer is no. Capital markets are becoming increasingly global in nature. Most are going through the process of deregulation, cost reduction, and increasing transparency. As this continues to occur, national laws will make less sense, and international rules will have to replace national ones.

Companies, on the other hand, are searching for a set of background laws which allow for smoother and less expensive operations. Which laws will prove to be smoother and less expensive will depend on the nature of the business, the expectations of employees, and the type of control structure which the shareholders require. In an internationally competitive environment, it is possible that certain firms will require extremely liberal sets of rules to provide the greatest flexibility for their operations. For this purpose supply-side laws will always exist. Extremely liberal laws, however, do not fulfil the requirement for efficient background laws set out in Chapter 2: namely a fixed set of laws which simultaneously facilitate smoother operations, increase surety of outcome and minimize transaction and agency costs. In a world without national economic styles all transaction and agency costs would be the same. But, as discussed in Chapters 3 and 4, different countries do have different national economic styles; it is these differences in national economic styles which may lead to a need for different sorts of national or regional background laws.

By advocating different types of efficient laws and describing different types of laws which should be propagated at various levels, the principle of subsidiarity is recommended. The primary question when trying to decide on which is the appropriate level for the provision of efficient laws should be the nature of the market to be regulated. Certain types of travel, transportation, communications, financial instruments, and some types of taxes, weapons and pollution all have international consequences and are therefore prime candidates for regulation at an international level. Certain types of pollution and economic activity (including immigration) have regional implications and might best be regulated at a regional level. Finally issues involving people and individual choices, including most taxation and market regulation issues, are better left to national or more local solutions.

In this context it seems to me that European Commission President Jacques Delors correctly analyzes the distortive effects of high-cost social legislation when he states that: "If we [the EC] were to have opting out [for laws] on social conditions it would erect a dangerous precedent and create a distortion of competition. It would make one country [Great Britain] a paradise for foreign investment, such as Japanese investment, and then Spain might ask for an opt-out on environmental rules." What he neglects to point out is that what is an efficient trade-off to him, a lower level of investment and economic activity in exchange for a higher level of social security legislation and environmental standards, may not be efficient for Great Britain or Spain.⁵⁵⁷ Only the people of Great Britain and Spain (and not Jacques Delors, the French, the Germans, the Russians, the Chinese or the United Nations), can answer the question of whether the benefits of legislation out-weigh its costs.

One should note that in the second part of this book, technological changes have been constantly referred to. Technological changes have led to dramatic changes in areas such as travel, transportation, communications, financial instruments, taxes, weapons and pollution. These technological changes have changed the subsidiarity

⁵⁵⁷ C. Goldsmith, "Aid Issue Threatens Summit, Delors Says", *International Herald Tribune* (December 6, 1991) p. 2.

calculation over time. Formerly the appropriate level for these areas of law was not international, but a more local, national or regional level. In a world which is changing rapidly and in which supply-side law is rampant, continued thought has to be given to the appropriate levels of law making.

This book has sought to provide a sensible basis for governments, lawyers, businessmen and economists to think about the interrelationship between laws and markets. Over time, technology has broken much of government's former power over taxation, capital, people, and the restriction of information. This loss of power puts serious constraints on governments that do not act efficiently or pass efficient laws. A new challenge emerges to the governments of the world at every level: repent and act efficiently or else capital, investment and ultimately your most competitive people will move to the utopian lands of efficient law.

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Summary

Laws, markets and efficiency should be considered simultaneously, as there is a natural reciprocal relationship between them. Rules and their enforcement will determine how markets operate. Markets will and do work. When markets are said to be "failing" or working "badly" it is not because the markets themselves "fail" or are "bad;" negative results occur when the set of rules under which the markets operate are either inherently inadequate, property rights are unclear or the rules may be adequate but improperly enforced. For law and economics and public choice purposes, efficiency is defined as the use of available resources in ways which bring about the maximum overall satisfaction possible, given the available technology. The only legitimate goal of public policy is to create efficient markets. Efficient commercial laws are those which fulfil certain necessary conditions namely: transaction and agency costs minimization, surety of outcome and aggregate satisfaction maximization. Countries have a strong economic incentive to pass the most efficient organizational forms possible. The fact that all countries have not adopted the same types of legal structures tends to indicate that various countries' national economic styles impose different transaction, agency, contracting and monitoring costs. The notion of what is efficient law has been almost revolutionized with the advent and diffusion of the microchip, fibre optic cable, satellite communication, the fax machine and better and cheaper international transport and communications. The advent of the microchip has destroyed bureaucracies. Bureaucracies were necessary when information was difficult to collect, collate, interpret and disseminate. Raw data is now fed onto a database. Anyone who knows how to interpret the data can directly and immediately obtain and interpret the necessary information flows without the help of middle management. In fact, in this process, middle managers who were once indispensable are now an absolute hindrance. This, along with a few other related factors, is the cause of constant corporate restructurings and massive white-collar job losses in private industry and privatizations by governments. Countries enact supply-side laws to attract people and businesses who are constricted in the straight-jacket of local national law and would like to find a cheap and convenient alternative.

Some countries are now spending more money to attract investment to their borders than is yielded by corporate income tax. Abolishing the corporate income tax would be more efficient than continuing to tax profitable businesses to cross-subsidize less profitable businesses. The Treaty of Maastricht will lead to European Disunion.

Samenvatting

Recht, markt en efficiëntie dienen niet los van elkaar gezien te worden, aangezien daartussen een natuurlijke wederkerige relatie bestaat. Regels en de handhaving daarvan bepalen het functioneren van de markt. Wanneer wordt gesteld dat markten "falen" of "slecht" functioneren dan is dit niet omdat de markt op zichzelf "faalt" of "slecht" is. Negatieve uitkomsten ontstaan als het samenstel van regels, waaronder de markt functioneert, inadequaat is, de eigendomsrechten onduidelijk zijn of wanneer de handhaving van adequate regels gebrekkig is. Vanuit het perspectief van de rechtseconomie en de economische theorie van de politieke besluitvorming dient efficiëntie geformuleerd te worden als de aanwending van de beschikbare middelen op zodanige wijze dat de totale behoeftenbevrediging gemaximaliseerd wordt, gegeven de stand van de technologie. Vanuit deze optiek is het enige legitieme doel van het overheidsbeleid zorg te dragen voor efficiënte markten.

Landen hebben er groot economisch belang bij zo efficiënt mogelijke organisatievormen te bezitten. Uit het feit dat niet alle landen over identieke juridische structuren beschikken, blijkt dat nationale economische stijlen uiteenlopende transactie-, agentschaps-, contract- en beheerskosten tot gevolg hebben. Voor een efficiënt handelsrecht zijn de volgende voorwaarden noodzakelijk: minimalisatie van de transactie- en agentschapskosten, zekerheid over de uitkomsten en maximalisatie van de totale behoeftenbevrediging.

De inhoud van het begrip efficiënt recht is nagenoeg veranderd door de komst en de verspreiding van de microprocessor, vezel-optische kabels, communicatie per satelliet, de faxmachine en betere en goedkopere transport- en communicatiemogelijkheden. De komst van de micro-processor heeft bureaucratieën vernietigd. Bureaucratieën waren noodzakelijk toen het moeilijk was informatie te verzamelen, samen te voegen, te interpreteren en te verspreiden. Tegenwoordig wordt informatie verzameld in een data-bank. Iedereen die de informatie kan interpreteren kan direct en onmiddellijk deze informatiestromen verkrijgen en interpreteren, zonder de hulp van middenkader. In dit proces vormt het eens zo onmisbare middenkader een belemmering. Tensamen met enkele andere verwante factoren is dit proces de oorzaak van voortdurende bedrijfsreorganisaties, het massale verlies aan "witte-boord"-banen in het bedrijfsleven en privatiseringen van overheidsinstellingen.

Landen introduceren wetten berustend op een aanbod-economie om personen en ondernemingen aan te trekken, die zich in het keurslijf bevinden van hun nationale wetgeving en die op zoek zijn naar een goedkoop en geschikt alternatief.

Sommige landen besteden tegenwoordig meer geld aan het aantrekken van investeringen dan de vennootschapsbelasting opbrengt. Afschaffing van de vennootschapsbelasting zou efficiënter zijn dan door te gaan met het belasten van winstgevendende bedrijven en uit de opbrengst daarvan subsidies te verstrekken aan minder winstgevendende ondernemingen.

Curriculum Vitae

Edward M. Aretz was born on January 5, 1958 in South Bend, Indiana, U.S.A. In 1980 he got his BA in Finance at the University of Indiana at Bloomington, Indiana. He became a doctor juris in 1987 at the Case Western Reserve University at Cleveland, Ohio. He is a member of the New York and Massachusetts Bar Association and the American Society of International Law. He has worked as a film critic for Fun City, trader at the futures market of the Chicago Board of Trade and as a lawyer at Wall Street. During his study at the University of Limburg he wrote besides his thesis on Efficient Law, two books, both entitled European Company Law, published by Euromoney and Simon G. Schuster. At the moment he is writing a new book on Managing in the New Economy; Why Big Business Failed.

Curriculum Vitae

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